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IN THE

Supreme Court of the United States

ASA INVESTERINGS PARTNERSHIP,
AlliedSignal Inc.
(now Honeywell International Inc.),
Tax Matters Partner,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

**On Petition for a Writ of Certiorari
to the United States Court of Appeals
for the District of Columbia Circuit**

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Does *Moline Properties, Inc.* v. *Commissioner*, 319 U.S. 436 (1943), establish (1) a single-prong "business purpose" test for determining whether an entity may be disregarded for Federal income tax purposes, as the D.C. Circuit held below in concluding that petitioner was a "sham," or (2) a two-pronged, alternative "business purpose or business activity" test, as *Moline* itself states and numerous other Courts of Appeals have held and under which, as the D.C. Circuit itself acknowledged below, petitioner must be respected for tax purposes?

2. Does *Commissioner* v. *Culbertson*, 337 U.S. 733 (1949), which focuses on the purpose and intent of the parties, apply to determine whether persons are partners in a partnership when they form an unincorporated venture in which capital is a material income-producing factor, as the D.C. Circuit held below, or does IRC Sec. 704(e)(1) override *Culbertson* and treat all persons who acquire a capital interest in such a venture as partners in a partnership, irrespective of their purpose and intent, as the Seventh Circuit has held?

3. If *Commissioner* v. *Culbertson*, *supra*, applies, can the purpose and intent of persons forming an unincorporated venture in which capital is a material income-producing factor properly be determined without considering whether they made capital contributions to the venture?

RULE 29.6 STATEMENT

Petitioner, ASA Investerings Partnership, was an investment partnership formed by AlliedSignal Inc. (AlliedSignal), AlliedSignal Investment Corporation (ASIC), Barber Corporation N.V. (Barber) and Dominguito Corporation N.V. (Dominguito). Of those four corporations, only AlliedSignal (now Honeywell International Inc.) has issued shares and/or debt securities to the public. Algemene Bank Nederland N.V. (now ABN Amro Bank N.V.), the indirect parent of Barber and Dominguito, has issued shares and/or debt securities to the public.

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IN THE SUPREME COURT OF THE UNITED STATES

ASA INVESTERINGS PARTNERSHIP,
AlliedSignal Inc.
(now Honeywell International Inc.),
Tax Matters Partner,
Petitioner,
v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

OPINIONS BELOW

The opinion of the United States Court of Appeals for the District of Columbia Circuit is reported at 201 F.3d 505 (D.C. Cir. 2000). The court's opinion is reproduced in the Appendix at pages 1a-23a. The court's orders denying rehearing and rehearing en banc are reproduced in the Appendix at pages 67a-68a.

The opinion of the United States Tax Court is reported at 76 T.C.M. (CCH) 325 (1998). It is reproduced in the Appendix at pages 24a-58a. The decision of the United States Tax Court is not reported. It is reproduced in the Appendix at pages 59a-66a.

JURISDICTION

The judgment of the United States Court of Appeals for the District of Columbia Circuit was entered on February 1, 2000. Petitioner's timely filed petitions for rehearing and rehearing en banc were denied on April 24, 2000. App. 67a-

68a. The jurisdiction of this Court is invoked under 28 U.S.C. Sec. 1254(1).

STATUTORY PROVISIONS AND REGULATIONS INVOLVED

The statutory provisions involved are Sections 453, 704 and 761 of the Internal Revenue Code of 1986. The relevant portions of those provisions are set forth in the Appendix at pages 69a-71a.

The Treasury Department regulations involved are Temp. Treas. Reg. Sec. 15A.453-1(c), Treas. Reg. Sec. 1.704-1(e), and Treas. Reg. Sec. 1.761-1(c). The pertinent portions of those regulations are set forth in the Appendix at pages 74a-79a.

STATEMENT

A. Relevant Facts

1. Background.

Petitioner was an investment partnership formed under New York law in April 1990. The partners were AlliedSignal Inc. (AlliedSignal, now known as Honeywell International Inc.); its wholly-owned subsidiary (ASIC); and Barber Corporation N.V. (Barber) and Dominguito Corporation N.V. (Dominguito), two newly-formed Netherlands Antilles corporations indirectly owned and controlled by Algemene Bank Nederland N.V. (ABN), a major Dutch bank.

The idea for the formation of an investment partnership such as petitioner was developed by Merrill Lynch. The partnership would invest in high-grade, interest-bearing securities and distribute the income from such investments to its partners. App. 26a-27a. Certain of its contemplated transactions would give rise to a potential tax benefit in the form of noneconomic capital losses. There would also be an opportunity to realize significant economic profits from movements in interest rates. AlliedSignal has acknowledged throughout that it would not have entered into the partnership but for the potential tax benefit.

At AlliedSignal's request, Merrill Lynch provided details of the proposal, including a suggested timetable for certain events. It also arranged for ABN to participate in the venture. ABN and AlliedSignal had a pre-existing business relationship. ABN viewed its participation in the partnership as a way to earn income while enhancing its business relationship with AlliedSignal. App. 7a and 29a.

2. Pre-Formation Activity.

At a meeting in Bermuda in April 1990, AlliedSignal and ABN agreed to form an investment partnership under New York law and to enter into a formal partnership agreement. At the Bermuda meeting, the parties also orally agreed that AlliedSignal would be responsible for all expenses of the partnership and would guarantee that the ABN partners would realize a return on their investment at least equal to ABN's funding costs. (In their subsequent calculations, the parties used LIBOR as the measure of ABN's funding costs.[1]) ABN requested an up-front $5 million fee for its participation. AlliedSignal agreed to pay the fee, but not in a lump sum and only after the occurrence of certain events contemplated by the parties. App. 8a.

Petitioner was funded with $1.1 billion of capital in April and May 1990. AlliedSignal and ASIC contributed $110 million and acquired a combined 10-percent interest in petitioner. Barber and Dominguito provided $990 million and acquired a combined 90-percent interest.

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[1] LIBOR is the acronym for the London Interbank Offering Rate, the benchmark interest rate used by European banks.

3. Petitioner's Investment Activity.

For a period of 25 months commencing in April 1990, petitioner used its capital to make numerous investments in a wide range of financial instruments. By the time petitioner was liquidated in June 1992, it had earned approximately $113 million in net profits from its investment activity. Those profits were fully reported on petitioner's U.S. partnership income tax returns. Petitioner made profit distributions to its partners at periodic intervals beginning in July 1990, and on a monthly basis beginning in February 1991. The ABN partners received more than $54 million as their share of petitioner's total net profit distributions; AlliedSignal and ASIC received more than $58 million.

The first securities acquired by petitioner in April 1990 were $850 million of private placement notes (PPNs) issued at face value by two banks identified by Merrill Lynch. Petitioner earned $5.8 million of interest on the PPNs before selling them, with the assistance of Merrill Lynch, to two unrelated banks at face value in mid-May 1990. As consideration, petitioner received $681.3 million in cash (including accrued interest) and eleven five-year LIBOR notes of the purchasers valued at $163.9 million.[2] (Costs of $6.375 million, significantly more

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[2] LIBOR notes have a "notional" (*i.e.*, hypothetical) principal amount. Payments made on a LIBOR note are the product of LIBOR times the notional principal amount. Because LIBOR is a floating rate of interest, the total amount to be received on a LIBOR note is uncertain. LIBOR notes thus constitute contingent payment obligations that provide their holder with an opportunity for an interest-rate play in the financial markets, regardless of the direction in which interest rates move. (Rising rates would increase both the amount to be received on the notes and their market value;

(continued...)

than what was anticipated, were imposed on the transaction by Merrill Lynch and were reflected in the reduced value of the LIBOR notes received.)

In the period from mid-May through June 1990, following the sale of the PPNs, petitioner invested in approximately 40 different issues of short-term commercial paper acquired on the open market. As those investments matured, the proceeds were regularly reinvested in new issues of commercial paper and other financial instruments.

4. Tax Consequences of PPN Sale.

For its first taxable year ended May 31, 1990, petitioner reported the sale of the PPNs as a contingent payment installment sale under Sec. 453 of the Internal Revenue Code of 1986 (IRC). Calculation of the gain or loss on such a sale was governed by Temp. Treas. Reg. Sec. 15A.453-1(c)(3), promulgated by the Treasury Department in 1981 in accordance with the specific direction of Congress. *See* IRC Sec. 453(j)(2); App. 70a.

Under the regulations, petitioner's cost basis in the PPNs was required to be recovered ratably over the six taxable years during which it would receive cash payments from the sale. (The effect of the regulations in most cases is to benefit respondent by permitting the early taxation of what is in fact a noneconomic, artificially calculated gain.) Petitioner realized a noneconomic capital gain of $539 million from the PPN sale, calculated as required by the regulations.[3] In accordance with

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[2] (...continued)
falling rates would create a profit opportunity through the use of "swaps" relating to the anticipated payment stream from the notes.)

[3] The receipt of cash proceeds of $680 million, less $141 million (continued...)

their respective partnership interests, petitioner allocated 10 percent of the gain to the AlliedSignal partners and 90 percent to the ABN partners.

The remaining 5/6 of the cost basis in the PPNs ($709 million) would be recovered ratably over the five additional taxable years in which payments were due on the LIBOR notes. Any loss on a note would be recognized on the earlier of final payment or a sale of the note. Temp. Treas. Reg. §15A.453-1(c)(3)(i); App. 74a-75a. A substantial portion of any such loss would likely be noneconomic.

5. AlliedSignal As Majority Partner in Petitioner.

As contemplated by the parties, in early August 1990, AlliedSignal acquired a majority interest in petitioner by purchasing Barber's entire interest and a portion of Dominguito's interest for a total purchase price of $540.6 million. AlliedSignal also paid the ABN partners $4.4 million of the $5 million fee ABN had requested in April.

At this time, interest rates had fallen and petitioner's LIBOR notes had declined in value. As a result, AlliedSignal paid the two ABN partners a total of $3.13 million less than their original investment for their respective partnership interests. App. 52a. Each of the ABN partners thus suffered a loss on its partnership interest.

AlliedSignal had no obligation to cover the ABN losses. They were, however, covered by hedges ABN had previously put in place with Merrill Lynch outside the partnership. Through an exchange of specifically structured payments, the hedges were designed to neutralize ABN's exposure to

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[3] (...continued)
of cost basis in the PPNs (representing 1/6 of their $850 million total cost basis), produced a noneconomic capital gain of $539 million.

fluctuations in the value of the LIBOR notes. When the hedges were terminated, ABN received a net payment of $5.85 million from Merrill Lynch. App. 47a.

Later in August 1990, as also contemplated by the parties, petitioner distributed the eleven LIBOR notes to AlliedSignal and ASIC and a proportionately equivalent amount of cash and financial instruments to Dominguito.[4] At this time, interest rates had returned to prior levels. As a result, Dominguito enjoyed the benefit of an increased portfolio valuation in receiving its share of the distribution.

AlliedSignal and ASIC sold some LIBOR notes in September and November 1990, and the balance in November 1992. Each sale resulted in a capital loss. As calculated in accordance with the regulations, a substantial portion of each loss was noneconomic. AlliedSignal utilized the capital losses as offsets against capital gains it had realized and on which it otherwise would have been taxed. Those gains included its 10-percent share of the noneconomic capital gain reported on the PPN sale. The resulting tax benefit to AlliedSignal was approximately $150 million, of which $19 million represented the tax it saved on the PPN gain.

6. AlliedSignal's Direct Payments to ABN.

In December 1991, the 20th month of petitioner's operation, AlliedSignal made a payment to Dominguito that included the remaining $600,000 of ABN's requested $5 million fee, about $765,000 to cover what the parties then agreed was the "shortfall" to date in petitioner's cumulative profit distributions to the ABN partners below a LIBOR-equivalent return on their investment, and $266,000 to cover certain other negotiated items.

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[4] Distribution of the LIBOR notes to AlliedSignal and ASIC ensured that they alone would ultimately absorb the embedded costs attributable to the PPN transaction.

When petitioner was liquidated in June 1992, the "shortfall" in petitioner's profit distributions was recalculated and found to be $152,000 less than in December 1991 because of petitioner's investment results since that time. To reflect that fact and certain other adjustments, the parties negotiated for a repayment of $315,000 from Dominguito to AlliedSignal.

The "direct payments" made by AlliedSignal to the ABN partners thus consisted of the $5 million fee, a net "shortfall" payment of $613,000, and $103,000 for other negotiated items. The profit distributions from petitioner to the ABN partners exceeded $54.4 million.

7. AlliedSignal's Investment Strategy.

AlliedSignal's overall investment strategy included, in addition to the receipt of its share of petitioner's profit distributions, the implementation of a series of floating-to-fixed interest rate swaps involving the LIBOR notes beginning in August 1990. Those swaps, which were structured quite differently than the ABN hedges, would enable AlliedSignal to take advantage of what it then anticipated would be a decline in interest rates beginning in the second half of that year.

Interest rates in fact fell steadily for an extended period beginning in November 1990. As a result, even though AlliedSignal incurred both economic and noneconomic losses on its LIBOR note sales, and even though its total costs and expenses had increased from an expected $11-12 million to an unexpected $25 million, AlliedSignal's investment strategy produced an overall pre-tax profit to it of $3.6 million. App. 22a-23a. If its costs had remained as expected, AlliedSignal's overall pre-tax profit would have been $16-17 million.

B. Proceedings Below

1. Tax Court Proceeding.

On audit, respondent objected to AlliedSignal's use of the capital losses realized on the LIBOR note sales without being taxed on 100 percent of the $539 million PPN capital gain reported by petitioner in May 1990.[5]

Respondent did not dispute that his regulations provided for the tax results claimed.[6] Rather, respondent asserted that petitioner was a "sham"; that the relationship between AlliedSignal and ABN was that of debtor-creditor; and that the transactions in question lacked economic substance and should be disregarded for tax purposes.

Petitioner's Tax Matters Partner (AlliedSignal) filed a timely petition in the United States Tax Court under IRC Sec. 6226(a)(1), contending that petitioner was a valid partnership,[7] that it had engaged in valid transactions, and that its application of the "ratable basis recovery" rules on the sale of its PPNs was expressly required by the Treasury regulations.

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[5] Despite the extensive involvement of ABN's New York branch in the activities of the partnership, there is no indication that respondent made any attempt to recover a capital gains tax from ABN or the ABN partners on their share of the PPN gain.

[6] On August 31, 1990, respondent published Notice 90-56, 1990-2 C.B. 344, stating his intention to amend the applicable regulations. No change has been made to date.

[7] IRC Sec. 761(a) defines a "partnership" as including a "...pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on...." App. 70a-71a.

The Tax Court first determined that Barber and Dominguito should be ignored, and that AlliedSignal and ABN were the real parties in interest. Relying on this Court's decision in *Commissioner* v. *Culbertson*, 337 U.S. 733 (1949), the Tax Court then held that AlliedSignal and ABN did not form a bona fide partnership because they did not have the requisite intent to join together in the present conduct of an enterprise. This conclusion was based on the court's view that the parties (1) had divergent business goals, (2) did not share in the venture's profits and losses, and (3) did not comply with their formal partnership agreement when it conflicted with their so-called Bermuda Agreement. App. 54a-55a.

The centerpiece of the Tax Court's opinion was a finding that AlliedSignal had agreed to provide (not guarantee) ABN a "specified return" of LIBOR plus 75 basis points (0.75 percent) on its invested funds, "no more and no less." App. 32a, 50a. Based on that finding, the court declared that the profit distributions made by petitioner to ABN ($54.4 million) were "an artifice" to enable AlliedSignal to pay ABN its "specified return," and that such distributions were supplemented by the "direct payments" from AlliedSignal ($5.7 million) to ensure that ABN received the precise amount it was promised by AlliedSignal. App. 50a.

The "specified return" finding was also used to support the Tax Court's second holding -- that the $990 million in funds provided by ABN had been "loaned" to AlliedSignal. The court equated its "specified return" finding with the finding of an agreement by AlliedSignal to pay interest of LIBOR plus 75 basis points on the loan. App. 57a.

The Tax Court did not consider whether the transactions entered into by petitioner lacked economic substance.

2. D.C. Circuit Proceeding.

On appeal, respondent conceded that ABN's $990 million cash outlay did not appear to be a loan to AlliedSignal because there was no obligation to repay any portion of the funds. (D.C. Cir. Res. Br. 49).

The D.C. Circuit (Williams, Sentelle and Henderson, JJ.) nevertheless agreed with respondent that the Tax Court's holding on the partnership issue was the equivalent of a finding that petitioner was "for tax purposes, a 'sham.'" App. 14a. The court found full support for the Tax Court's position in this Court's decision in *Moline Properties, Inc.* v. *Commissioner*, 319 U.S. 436 (1943), a case not relied on by respondent or cited by the Tax Court.

Although the court acknowledged that petitioner engaged in extensive investment activity for two years, it rejected petitioner's argument that *Moline* set forth a two-pronged "business purpose or business activity" test under which petitioner could not be considered a sham. Rather, the court concluded that *Moline* set forth a single-prong "unitary" test, under which "the absence of a nontax business purpose is fatal." App. 15a.

The court concluded that because petitioner was formed for a tax avoidance purpose, and because its purchase and sale of the PPNs in April and May 1990 was business activity undertaken in furtherance of that purpose, petitioner was properly treated as a sham under *Moline*.

The court below also reviewed the Tax Court's *Culbertson* analysis, finding some of it "misdirected." App. 14a. It disagreed with the Tax Court's first point -- that the existence of divergent business goals was a proper basis for denying partnership treatment. App. 14a. It did not comment on the Tax Court's third point -- that the parties did not follow their partnership agreement when it conflicted with their so-called Bermuda Agreement.[8]

On the Tax Court's second point -- that the parties did not share in the venture's profits and losses, the court stated that it found "no clear error in the [Tax Court's] findings that the direct payments made to ABN were to compensate it merely for its funding costs . . . (plus some amount above LIBOR, even if not 75 basis points)." App. 19a. Although the court thus accepted petitioner's contention that ABN had not been promised a "specified return" of LIBOR plus 75 basis points by AlliedSignal, it said nothing about why the $54.4 million in distributions that ABN received from petitioner did not represent a sharing in petitioner's profits.

With respect to loss-sharing within the partnership, the court below refused to recognize the $3.13 million loss suffered by the ABN partners attributable to the decline in value of petitioner's LIBOR notes in August 1990. The court's justification was that ABN's exposure to such losses had been eliminated through its hedges with Merrill Lynch, notwithstanding that the hedges were put in place by ABN outside the partnership.

Even though there were no Tax Court findings on the point, the court speculated that AlliedSignal "likely" paid for the ABN hedges because it had paid a substantial fee to Merrill Lynch. App. 22a. On the basis of its own speculation, the court viewed AlliedSignal as having "insured" ABN against loss on the value of the LIBOR notes while they were held by petitioner, an action said not to be within the "traditional notion of partnership."[9] App. 22a.

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[8] Treas. Reg. Sec. 1.761-1(c) provides that a "partnership agreement" includes the original agreement and any modifications thereof agreed to by all the partners, whether in oral or written form. App. 79a.

As for other possible partnership losses, the court concluded that ABN had no credit risk with respect to any of petitioner's other investments because they were AAA- and AA-rated and any such risk was therefore "de minimis." App. 21a. The credit risk on the hedge payments ABN was to receive from Merrill Lynch, a single A-rated credit, was also considered "de minimis" by the court. App. 21a.

The court did not address petitioner's argument that IRC Sec. 704(e)(1), rather than *Culbertson*, should be applied to determine whether AlliedSignal and ABN were partners in a partnership.[10] Rather, the court concluded that petitioner was not a valid partnership because neither party had the requisite purpose and intent to form a bona fide partnership, as required under *Culbertson*.

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[9] The court took no note of the fact that AlliedSignal's $6.75 million fee to Merrill Lynch was payable in four installments over 14 months, that the bulk of the fee was payable well after ABN's hedges had been closed out, and that AlliedSignal delayed payment of the final installment for 17 additional months and then paid Merrill Lynch only $2.3 million of the final $2.8 million due because of its dissatisfaction with the PPN and LIBOR note transaction costs Merrill Lynch had imposed. (D.C. Cir. Jt. App. 0161-62.) On the profit side, the court took no note of the fact that the $5.85 million net payment ABN received from Merrill Lynch on its hedges far exceeded the $3.13 million in losses it suffered as a result of the decline in value of the LIBOR notes in August 1990.

[10] IRC Sec. 704(e)(1) provides that "A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person." App. 70a.

Although respondent conceded that ABN's $990 million cash outlay did not appear to be a loan to AlliedSignal because there was no repayment obligation, the court declined to consider petitioner's argument that the funds must have constituted a capital contribution by ABN to petitioner. The court described the loan/capital contribution issue as "quite peripheral" to the question whether the parties had entered into a bona fide partnership. App. 22a.

REASONS FOR GRANTING THE WRIT

The instant case presents one of the most fundamental questions arising under the Federal income tax laws -- when must an entity be respected for tax purposes, and when may it be disregarded as a "sham"?

The decision below is in direct conflict with the governing principles enunciated by this Court in *Moline Properties, Inc.* v. *Commissioner*, 319 U.S. 436 (1943). *Moline* sets forth a two-pronged, alternative test for determining when an entity should be respected for tax purposes -- if there is a valid business purpose for the formation of the entity, or it conducts business activity after being formed, the entity cannot be disregarded.

The D.C. Circuit expressly acknowledged that petitioner had engaged in extensive investment activity over a two-year period. But the court concluded that *Moline* set forth only a single-prong "business purpose" test, under which petitioner was properly disregarded as a sham.

The decision below is also in direct conflict with decisions of the Second[11] and Seventh[12] Circuits that have applied *Moline* to respect the existence of an entity that conducted business activity, even though the entity was formed for a tax avoidance purpose and carried on its activity in furtherance of that purpose.

In addition, the decision below is in direct conflict with a decision of the Seventh Circuit[13] regarding the application of IRC Sec. 704(e)(1), rather than this Court's decision in *Commissioner* v. *Culbertson*, *supra*, to determine whether parties forming an entity such as petitioner, in which capital is a material income-producing factor, should be treated as partners in a valid partnership.[14] Moreover, if *Culbertson* governs, the decision below conflicts with *Culbertson* itself on the significance of a participant's capital contribution to the venture.

The instant case is an extremely important case, because the D.C. Circuit is the only circuit to which appeals may be taken by partnerships no longer in existence. IRC Sec. 7482(b)(1); App. 72a-73a. As a result, if the decision below is left unreviewed, numerous partnerships may find themselves governed by the "single-prong" *Moline* test and/or the *Culbertson* rationale adopted below, while other partnerships subject to the law of other circuits would likely be governed by the "two-pronged" alternative test actually set forth in *Moline* and/or a proper application of Sec. 704(e)(1).[15]

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[11] *Gregg Co. of Delaware* v. *Commissioner*, 239 F.2d 498 (2d Cir. 1956), *cert. denied*, 353 U.S. 946 (1957).

[12] *Northern Indiana Pub. Serv. Co.* v. *Commissioner*, 115 F.3d 506 (7th Cir. 1997).

[13] *Evans* v. *Commissioner*, 447 F.2d 547 (7th Cir. 1971). *Compare Bayou Verret Land Co.* v. *Commissioner*, 450 F.2d 850 (5th Cir. 1971).

[14] *See supra* note 10.

To resolve the *Moline* conflicts noted above, to clarify whether Sec. 704(e)(1) takes precedence over *Culbertson* where capital is a material income-producing factor in the venture, and to eliminate the confusion that is certain to develop among the lower courts as a result of the decision below, this Court should grant the writ.

I. The Decision Below Is in Direct Conflict with the Principles Enunciated by This Court in *Moline Properties, Inc.* v. *Commissioner*, 319 U.S. 436 (1943).

This Court first enunciated the governing principles for determining whether an entity is a "sham" for tax purposes in its landmark decision in *Moline Properties, Inc.* v. *Commissioner*, 319 U.S. 436 (1943). In *Moline*, this Court refused to disregard a corporation established by an individual at the behest of a creditor. This Court declared that a corporation must be respected for tax purposes if (1) it is formed for a business purpose, or (2) it conducts business activity after its formation. As this Court stated:

> The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to

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[15] The *Moline* aspect of the instant case is not limited to partnerships. Corporations having the D.C. Circuit as their venue for appeal will also find themselves faced with that court's single-prong interpretation of *Moline*.

> serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity. * * *
>
> In general, in matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal. In such situations the form is a bald and mischievous fiction.

319 U.S. at 438-39 (emphasis added; footnotes omitted).

Lower courts have applied the two-pronged test of *Moline* on countless occasions, both to corporations and to partnerships. *Moline* is surely one of the most frequently cited tax cases ever decided.[16]

Notwithstanding the clear language of *Moline*, however, the D.C. Circuit chose to craft its own single-prong, so-called "unitary" test, under which "the absence of a nontax business purpose is fatal." App. 15a. The court expressly acknowledged that if "business activity" were a separate aspect of the *Moline* test, petitioner could not be treated as a sham.

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[16] For a sampling of Court of Appeals decisions applying *Moline* generally, see, *e.g.*, *Sargent* v. *Commissioner*, 929 F.2d 1252, 1259 (8th Cir. 1991); *Gulf Oil Corp.* v. *Commissioner*, 914 F.2d 396, 411 (3d Cir. 1990); *Humana Inc.* v. *Commissioner*, 881 F.2d 247, 252 (6th Cir. 1989); *Vaughn* v. *United States*, 740 F.2d 941, 943 (Fed. Cir. 1984); *Taylor* v. *Commissioner*, 445 F.2d 455, 457 (1st Cir. 1971); *Dodd* v. *Commissioner*, 298 F.2d 570, 577-78 (4th Cir. 1962).

See also the following Tax Court decisions: *Bertoli* v. *Commissioner*, 103 T.C. 501, 511-12 (1994) (partnership); *Bass* v. *Commissioner*, 50 T.C. 595, 600 (1968) (corporation); *Campbell County State Bank, Inc.* v. *Commissioner*, 37 T.C. 430, 441 (1961), *rev'd on other grounds*, 311 F.2d 374 (8th Cir. 1963) (partnership).

> We agree if engaging in business activity were sufficient to validate a partnership ASA would qualify. It was infused with a substantial amount of capital ($1.1 billion), and invested it in PPNs, LIBOR notes, and other short-term notes over a period of two years.

App. 15a. But the court concluded that "courts have understood the 'business activity' reference in *Moline* to exclude activity whose sole purpose is tax avoidance," App. 15a, and that petitioner's purchase and sale of the PPNs was "a business activity merely conducted for tax purposes." App. 16a. On that basis, the D.C. Circuit upheld the Tax Court's determination that petitioner was a sham.

The two cases cited by the court in support of its narrow reading of *Moline* were *National Investors Corp.* v. *Hoey*, 144 F.2d 466 (2d Cir. 1944), and *Zmuda* v. *Commissioner*, 731 F.2d 1417 (9th Cir. 1984). Neither case supports the proposition for which it was cited.

National Investors did not hold that the corporation at issue could be disregarded as a sham on the ground that it had a tax avoidance purpose, or because it carried on activity in furtherance of such a purpose. To the contrary, the Second Circuit (L. Hand, J.) held that the corporation should be respected for as long as it engaged in business activity. The presence or absence of a tax avoidance purpose while the corporation conducted business activity was not even discussed.[17]

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[17] See *Jackson* v. *Commissioner*, 233 F. 2d 289, 290-91 (2d Cir. 1956), for an explanation of *National Investors* and a reaffirmation of the two-pronged *Moline* test by the Second Circuit. See also *Bass* v. *Commissioner*, 50 T.C. at 600, citing *National Investors* in support of its (continued...)

In *Zmuda*, the other case cited below, the Ninth Circuit held that certain trusts could be disregarded after determining that the trusts lacked both a business purpose and business activity. Any doubt that the Ninth Circuit adheres to the two-pronged *Moline* test should be eliminated by that court's pre-*Zmuda* opinion in *O'Neill* v. *Commissioner*, 271 F.2d 44, 49 (9th Cir. 1959), and the post-*Zmuda* opinion of Judge, now Justice, Kennedy in *Betson* v. *Commissioner*, 802 F.2d 365, 367 (9th Cir. 1986) ("A corporation exists for tax purposes if formed for a business purpose or if it carries on business after incorporation.").

Concern regarding the tax advantages of a particular investment transaction is no justification for a lower court decision that is in clear contravention of this Court's pronouncements. Here, the court below was quite concerned about the tax-motivated aspects of the PPN purchase and sale. App. 16a. But that concern properly goes to the question of economic substance (an issue left unaddressed by both courts below), and not to whether a partnership that invests its capital in a wide range of financial instruments for a period of 25 months is a "sham" for the entire period of its existence. The clear misinterpretation and misapplication of *Moline* by the court below requires review by this Court.[18]

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[17] (...continued)
articulation of the two-pronged *Moline* test.

[18] The D.C. Circuit also inexplicably cited *Knetsch* v. *United States*, 364 U.S. 361 (1960), as support for its view that the inquiry in "sham" cases "turns on the existence of a nontax business motive." App. 15a. In *Knetsch*, a "sham transaction" case, this Court expressly "put aside" the taxpayer's motive and applied the principles of *Gregory* v. *Helvering*, 293 U.S. 465 (1935), to decide "'whether what was done, apart from the tax motive, was the thing which the statute intended.'" 364 U.S. at 365 (quoting
(continued...)

II. The Decision Below Is in Direct Conflict with Decisions of the Second and Seventh Circuits on the Meaning and Application of *Moline*.

The decision of the D.C. Circuit is in direct conflict with decisions in at least two other circuits that have upheld the existence of an entity under the "business activity" prong of *Moline*, even though the entity was formed for a tax avoidance purpose and carried on its activity in furtherance of that purpose.

In *Northern Indiana Pub. Serv. Co.* v. *Commissioner*, 115 F.3d 506 (7th Cir. 1997), *aff'g* 105 T.C. 341 (1995), a U.S. parent company established a Netherlands Antilles subsidiary to borrow U.S. dollars in the Euromarket and on-loan the funds to the parent. The subsidiary's sole purpose was to enable the parent to avoid the U.S. withholding tax that would otherwise have been imposed on interest paid directly to foreign lenders. Respondent sought to disregard the subsidiary's role under various theories. The Seventh Circuit held that the subsidiary had to be respected under *Moline*. The court read *Moline* as standing for the proposition that:

> [A] corporation and the form of its transactions are recognizable for tax purposes, despite any tax-avoidance motive, so long as the corporation engages in bona fide economically-based business transactions.

115 F.3d at 512 (emphasis added).

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[18] (...continued)
Gregory v. *Helvering*, 293 U.S. at 469) (emphasis added).

Knetsch does not in any way support the D.C. Circuit's view that the presence or absence of a business purpose is the sole test for determining sham treatment.

In *Gregg Co. of Delaware* v. *Commissioner*, 239 F.2d 498 (2d Cir. 1956), *cert. denied*, 353 U.S. 946 (1957), a corporation admittedly formed as part of a plan to avoid U.S. tax argued that it should be disregarded under *Moline*. The Second Circuit rejected the argument because the corporation had engaged in business activity by performing the functions for which it was created. Significantly, *Gregg* cited *National Investors*, *supra*, in support of its conclusion.

As can be seen, the Second and Seventh Circuits have both interpreted *Moline* as holding that an entity must be respected for tax purposes if it has engaged in bona fide business activity -- even if the entity was formed for a tax avoidance purpose and carried on its activity in furtherance of that purpose. The position of the D.C. Circuit below is thus in direct conflict with the position of at least two other circuits on this fundamental issue.[19]

Given the far-reaching significance of the question here presented, it is essential that this Court resolve the conflict that now exists among the circuits.

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[19] *See also Keller* v. *Commissioner*, 723 F.2d 58 (10th Cir. 1983), *aff'g* 77 T.C. 1014, 1030-31 (1981) (affirming, on basis of Tax Court's reasoning, decision respecting existence of professional service corporation engaged in business activity, whether or not formed for tax avoidance purpose); *Shaw Constr. Co.* v. *Commissioner*, 323 F.2d 316, 320-21 (9th Cir. 1963), *aff'g* 35 T.C. 1102, 1114 (1961) (affirming Tax Court holding disregarding corporations under *Moline* because they were formed for tax avoidance purposes and were not engaged in income-producing business activity); *Kimbrell* v. *Commissioner*, 371 F.2d 897 (5th Cir. 1967)(corporation disregarded where no valid business purpose and no business activity); *Bertoli* v. *Commissioner*, *supra* (absence of business purpose does not by itself require sham determination).

III. The Decision Below Conflicts with the Position of the Seventh Circuit and with *Commissioner* v. *Culbertson* Itself on Whether and How *Culbertson* Applies in Circumstances Such As Those Here Presented.

In addition to the conflict created by the D.C. Circuit's interpretation of *Moline*, that court's affirmance of the Tax Court's *Culbertson* analysis has created an additional conflict within the circuits requiring review by this Court. Specifically, the decision below is in direct conflict with *Evans* v. *Commissioner*, 447 F.2d 547 (7th Cir. 1971), with respect to the proper roles of IRC Sec. 704(e)(1) and *Culbertson* in determining whether persons are partners in a partnership in which capital is a material income-producing factor.

This Court's trilogy of family partnership decisions in the late 1940s[20] engendered considerable confusion among the lower courts regarding the proper test to be applied in determining whether a valid partnership had been created. H.R. Rep. No. 586, 82d Cong., 1st Sess. (1951), *reprinted in* 1951 U.S.C.C.A.N. 1781. In 1951, Congress responded to the confusion by enacting what is now IRC Sec. 704(e)(1).[21] *Id.* That provision established an objective test for determining whether a person becomes a partner in a partnership in which capital is a material income-producing factor, by focusing on whether the person acquired a capital interest in the venture.[22]

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[20] *Commissioner* v. *Tower*, 327 U.S. 280 (1946); *Lusthaus* v. *Commissioner*, 327 U.S. 293 (1946); *Culbertson, supra.*

[21] *See supra* note 10.

[22] A "capital interest" is defined in the pertinent regulations as "an interest in the assets of the partnership, which is distributable to the owner

(continued...)

In *Evans*, the Seventh Circuit held that Sec. 704(e)(1) overrides *Culbertson* in determining the status of persons as partners in any partnership in which capital is a material income-producing factor, whether or not the partnership involves family members. *Evans* involved the termination of an existing partnership and the creation of a new partnership in its place. The court held that the taxpayer's transfer to his corporation of his 50 percent capital interest in the old partnership resulted in a new partnership between the corporation and the other, unrelated 50 percent partner, even though the other partner never consented to having the corporation as his new partner.

The *Evans* court stated: "If the corporation's ownership is real then the subjective intent of the parties is not a determinative test." 447 F.2d at 550. It then quoted from an earlier Seventh Circuit decision, as follows:

> The test is no longer whether the parties acted in good faith with a business purpose in joining together to conduct a partnership business. This was the test set forth in *Commissioner* v. *Culbertson*, 337 U.S. 733 (1949), which was decided before present Sec. 704(e)(1) was part of the Code. * * * The emphasis has shifted from "business purpose" to "ownership of a capital interest." * * *

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[22] (...continued)
of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership." Treas. Reg. Sec. 1.704-1(e)(1)(v); App. 79a. Under the terms of petitioner's partnership agreement, each partner contributing capital was entitled to a distribution of assets in proportion to its contribution, either on withdrawal or upon liquidation. (D.C. Cir. Jt. App. 0823, 0833-35.)

Id. at 551, quoting from *Pflugradt* v. *United States*, 310 F.2d 412, 415 (7th Cir. 1962).

According to the Seventh Circuit, in any case involving an unincorporated venture where capital is a material income-producing factor, the threshold test for determining a participant's status as a partner in a partnership is whether the participant acquired a capital interest in the venture.[23] (Like the Seventh Circuit, the Tax Court has applied Sec. 704(e)(1) in considering the status of persons as partners in newly-created partnerships. *See, e.g.*, *Ketter* v. *Commissioner*, 70 T.C. 637 (1978), *aff'd without opinion*, 605 F.2d 1209 (8th Cir. 1979); *Carriage Square, Inc.* v. *Commissioner*, 69 T.C. 119 (1977).)

Here, the D.C. Circuit concluded that whether ABN made a capital contribution to, and thereby acquired a capital interest in, petitioner was "quite peripheral to the central issue of whether the parties entered into a bona fide partnership." App. 22a. Its refusal even to consider the question puts it in direct conflict with the Seventh Circuit on this point.

In addition, the D.C. Circuit's failure to acknowledge the relevance of whether ABN had made a capital contribution to petitioner constitutes a clear misapplication of *Culbertson* itself. This Court there made it clear that all facts and circumstances are to be considered in determining whether a bona fide partnership has been formed. In summarizing the analysis contemplated by *Culbertson*, this Court confirmed that whether a participant has contributed capital to the venture is one critical factor that cannot be ignored.

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[23] Under the Seventh Circuit's test, *Culbertson* remains relevant where the participant has not acquired a capital interest in the venture, as the Tax Court concluded below with respect to ABN, or where capital is not a material income-producing factor in the venture.

The Fifth Circuit apparently takes a contrary view. *See Bayou Verret Land Co.* v. *Commissioner*, 450 F.2d 850 (5th Cir. 1971).

> If, upon a consideration of all the facts, it is found that the partners joined together in good faith to conduct a business, having agreed that the services or capital to be contributed presently by each is of such value to the partnership that the contributor should participate in the distribution of profits, that is sufficient.

337 U.S. at 744-45. The D.C. Circuit's failure to recognize the relevance of whether ABN had made a capital contribution to petitioner reflects a complete misunderstanding of *Culbertson*. Under either *Culbertson* or Sec. 704(e)(1), therefore, the court's refusal to determine the nature of ABN's cash outlay conflicts with the governing law.

IV. The Instant Case is One of Considerable Importance In the Area of Partnership Taxation Involving Corporations.

The instant case raises fundamental issues affecting partnership taxation in a nonfamily setting. The questions here presented are particularly significant in the current tax environment. Lower courts are being asked with considerable frequency to determine whether the use of a particular business or investment structure by a corporation, or the implementation of a particular series of transactions, constitutes an acceptable "tax minimization plan" or an unacceptable "corporate tax shelter."

Fundamental questions such as those here involved go to the very essence of that determination. Partnerships are the entity of choice for many commercial and financial joint ventures entered into by unrelated corporations. Yet, this Court has not revisited the basic partnership issues here presented since Congress enacted the predecessor of Sec. 704(e)(1) in 1951.

Moreover, the D.C. Circuit is the only circuit for appeals by partnerships no longer in existence. If the decision below is left unreviewed, the outcome for two virtually identical commercial partnerships formed by the same participants will almost certainly be different if, by the time their status is challenged, one partnership has been terminated and must appeal to the D.C. Circuit, while the other remains in existence and is able to appeal to the Seventh Circuit or to another circuit that agrees with the positions of that court in this area.

Review of the decision below will afford this Court the opportunity to resolve the conflict between the D.C. Circuit and the other circuits on the applicability of *Moline* and of Sec. 704(e)(1), as well as to clarify how *Culbertson* is intended to be applied in a nonfamily context in the event Sec. 704(e)(1) does not apply.

CONCLUSION

For all of the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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June 30, 2000

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United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

Argued October 19, 1999 Decided February 1, 2000

No. 98-1583

ASA INVESTERINGS PARTNERSHIP, ET AL.,
APPELLANTS

v.

COMMISSIONER OF INTERNAL REVENUE,
APPELLEE

Appeal from the United States Tax Court

(No. TAX-27320-96)

Jerome B. Libin argued the cause for appellants. With him on the briefs was *Steuart H. Thomsen.*

Edward T. Perelmuter, Attorney, U.S. Department of Justice, argued the cause for appellee. With him on the brief were *Loretta C. Argrett,* Assistant Attorney General, and *Richard Farber,* Attorney.

Bills of costs must be filed within 14 days after entry of judgment. The court looks with disfavor upon motions to file bills of costs out of time.

Before: WILLIAMS, SENTELLE and HENDERSON, *Circuit Judges.*

Opinion for the Court filed by *Circuit Judge* WILLIAMS.

WILLIAMS, *Circuit Judge*: In January 1990 AlliedSignal, a company manufacturing aerospace and automotive products, decided to sell its interest in Union Texas Petroleum Holdings, Inc., an oil, gas, and petrochemical company. Anticipating a large capital gain, it sought to reduce the resulting tax burden by entering into a set of transactions via a partnership with several foreign corporations. The transactions took advantage of provisions of the Internal Revenue Code (and related regulations) designed to yield reasonable results when property is sold on an installment basis and the value of the installment payments cannot be known in advance. With the help of these provisions, transactions that in substance added up to a wash were transmuted into ones generating tax losses of several hundred million dollars; the offsetting gains were allocated to foreign entities not subject to United States income tax at all.

The Commissioner of Internal Revenue in 1996 issued a notice of final partnership administrative adjustment, reallocating to AlliedSignal much of the capital gain accrued by the partnership. ASA, via its "Tax Matters Partner," AlliedSignal, petitioned for relief in the Tax Court, which agreed with the Commissioner that AlliedSignal had not entered into a bona fide partnership and upheld the Commissioner's determination. *ASA Investerings Partnership, AlliedSignal, Inc., Tax Matters Partner v. Commissioner*, 76 T.C.M. (CCH) 325 (1998) ("Tax Court Decision"). We affirm.

* * *

The hardest aspect of this case is simply getting a handle on the facts. To make them manageable, we first discuss the principal tax provisions in question and then show their application through a series of examples, ending with a simplified version of the transactions here. Only then do we lay out the exact transactions themselves.

Under the general provisions of the Internal Revenue Code ("IRC"), gains and losses are generally "realized" in the year that they are received or incurred. See 26 U.S.C. § 1001 (1994). A sale for future payments, however, presents several difficulties, among them that the deferred payment may be contingent in amount or otherwise not susceptible to accurate valuation. Section 453 of the Internal Revenue Code, 26 U.S.C. § 453, provides methods for taxation of such an "installment sale," defined as "a disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs." *Id.* § 453(b)(1). It specifies the "installment method" for such a sale, providing that "the income recognized for any taxable year from a disposition is that proportion of the payments received in that year which the gross profit . . . bears to the total contract price." *Id.* § 453(c). Thus, if A owns a building with a basis of $100, and sells it for $300 to be paid in five $60 annual installments, A recognizes a taxable gain of $40 each year. The proportion of "gross profit" to "total contract price" is 200/300 or two thirds, so the income recognized for each year is two thirds of the receipts of that year.

In 1980 Congress expanded § 453, authorizing the Secretary to make the installment method available to deferred payment transactions for which the sales price is indefinite, or subject to a contingency. Section 453(j) (previously § 453(i)) mandates that the Secretary shall promulgate regulations "providing for ratable basis recovery in transactions where the gross profit or the total contract price (or both) cannot be readily ascertained." In response, the Treasury promulgated Temp. Treas. Reg. § 15A.453-1(c)(3)(i) (1981), which provides that in contingent payment sales (and subject to irrelevant exceptions), "the taxpayer's basis . . . shall be allocated to the taxable years in which payment may be received under the agreement in equal annual increments."

Under these regulations, the taxpayer will have a recognized gain in years when payment from the sale exceeds the basis recovered; in years when payment is less than the basis recovered, "no loss shall be allowed unless the taxable year is the final payment year under the agreement or unless it is otherwise determined . . . that the future payment obligation under the agreement has become worthless." *Id.*

The following examples should illustrate the ratable basis recovery rule. Property owner, A, sells a house with a basis and current value of $1 million in exchange for an instrument that will pay unpredictable amounts (e.g., a share of the property's gross profits) over a five-year period. In any year in which the payout equals or exceeds $200,000, A will recover $200,000 in basis under the ratable basis recovery rule and will have a taxable gain equal to the difference between the amount received from the note and $200,000. In a year in which the payout is less than $200,000, A will not report a loss, but instead will recover a portion of the basis equal to the payout; the unused basis will then be carried forward to the next year. See *id.* § 15a.453-1(c)(3), example (2). Under the rule just quoted above, unused basis would be recovered only in the last year of scheduled payout.

The rule works similarly when the seller receives *both* an instrument with indefinite value and an immediate payment of cash. In a variation on the preceding case, for example, suppose A sells the property for a $500,000 cash payment and an indefinite five-year instrument. Once again, the basis is recovered over the course of five years. In the first year, A recovers $200,000 in basis; because he has received $500,000 that year, he must report a gain of $300,000. If A sells the note in Year 2 for $500,000, he can report a loss of $300,000, equal to the difference between the remaining basis in the note ($800,000) and the $500,000 he has received in exchange for the note.[1] In this example, of course, the results are rather unappealing to the taxpayer: although he had no real gain, he recognized a nominal one early, offset by an equal tax loss--but one that was deferred and therefore not a complete offset. Because of the rule against any recovery of basis in excess of gross receipts in any year except the last, the taxpayer cannot manipulate the timing in his favor.

But suppose A finds a way of allocating the nominal tax gain to a tax-free entity, reserving for himself a nominal tax loss? Here is how he might do it: He forms a partnership with a foreign entity not subject to U.S. tax, supplying the partnership with $100,000 and inducing the "partner" to supply $900,000. The "partnership" buys for $1,000,000 property eligible for installment sale treatment under § 453, and, as the ink is drying on the purchase documents, sells the property, as in the last example, for $500,000 in cash and an indefinite five-year debt instrument. The cash payment produces a gain of $300,000, 90% of which goes to the nontaxable foreign entity. Then ownership adjustments are made so that A owns 90% of the partnership. In year 2 the instrument is sold, yielding a tax loss of $300,000, 90% of which is allocable to A. Presto: A has generated a tax loss of $240,000 ($270,000 loss in Year 2, offset by $30,000 gain in Year 1), with no material change in his financial position--other than receipt of the valuable tax loss. This example is AlliedSignal's case, stripped to its essentials.

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[1] The regulation does not appear to provide expressly that in the event that the taxpayer completely liquidates the instrument before the end of scheduled payout he may recover all unused basis in that year. Both parties agree, however, that this is the case.

Now for the specifics of this case: In 1990, AlliedSignal anticipated that it would soon realize a capital gain of over $400 million from the sale of its interest in Union Texas Petroleum Holdings, Inc. In February, AlliedSignal approached Merrill Lynch & Co. to discuss a set of transactions that Merrill had developed to create tax losses to shelter anticipated capital gains.

Under the plan AlliedSignal would form a partnership with a foreign entity, which in turn would supply the majority of the capital for and assume a majority stake in the partnership. In Year 1, the partnership would purchase short-term private placement notes ("PPNs"), which can be sold under the installment method of accounting provided for in IRC § 453. See 26 U.S.C. § 453(k)(2)(A) (implying that the sale of "stock or securities which are [not] traded on an established securities market" would be subject to the installment method). Several weeks later, the partnership would sell the instruments for 80% cash and 20% debt instruments, which would pay out over several years and thus would be subject to the ratable basis recovery rule. As in the example above, the partnership would report a large gain in the first year, equal to the difference between the substantial cash payment and the small share of basis recovered that year. The gain would be allocated according to each partner's interest, with the tax-exempt foreign partner receiving the lion's share.

The next year, AlliedSignal would acquire a majority interest in the partnership, and sell the debt instruments. The sale would create a large tax loss because the basis available for recovery would far exceed the value of the instruments.

Merrill would serve as the partnership's financial adviser and, for a $7 million fee, would recruit the foreign partner and arrange for the subsequent investments. Tax Court Decision, 76 T.C.M. at 326. Merrill would also "structure and enter into the requisite swap transactions" with the banks, "[t]o ensure a market for [the] issuance and sale" of the PPNs and the debt instruments to be received on their sale. *Id.* In exchange for serving as the partnership's financial intermediary, Merrill would receive roughly $1 to 2 million on the initial sale of PPNs, and $200,000 to $400,000 on the sale of the subsequent debt instruments. *Id.* The foreign partner would receive the greater of $2,850,000 or 75 basis points (1 basis point = .01%) over the London International Bank Offering Rate ("LIBOR") on any funds contributed to the partnership, as well as reimbursement of all partnership expenses incurred. *Id.*

AlliedSignal and Merrill followed the proposal to the letter. Merrill contacted Algemene Bank Netherlands N.V. ("ABN"), one of the Netherlands' largest commercial banks. *Id.* at 327. ABN had previously participated in similar Merrill transactions, and anticipated that this partnership would strengthen its preexisting lending relationship with AlliedSignal. *Id.* On April 5, 1990 Johannes den Baas, Vice President of Corporate Finance for ABN New York, an ABN affiliate, requested authorization to enter into this venture. *Id.* Den Baas recommended the creation of two "special purpose corporations" ("SPCs"), to which ABN would lend $990 million, and which would then contribute this money to the venture. *Id.* The purpose of this structure, den Baas said, was (1) to permit ABN, which would otherwise be a general partner in the venture with AlliedSignal, to limit its exposure to liability, and (2) to facilitate ABN's shifting part of the loan to other banks for various reasons.

On April 17 and 18, den Baas and another representative of an ABN affiliate met in Bermuda with a representative of AlliedSignal. *Id.* Both sides agreed that AlliedSignal would pay all partnership expenses, as well as ABN's costs funding the requisite loans to the partnership (approximately LIBOR), plus 75 basis points. *Id.* at 328.[2] The precise amount, of course, would depend an the amount that ABN contributed and how long the partnership, to be known as ASA Investerings, held those funds. In response to den Baas's request that AlliedSignal pay $5 million up-front, the parties agreed that AlliedSignal would instead periodically make "premium" payments upon the occurrence of certain events. *Id.* The agreements reached during these negotiations were referred to by the Tax Court as the "Bermuda Agreement."

ABN's Risk Management Division expressed concern that a loss might arise out of the sale of the PPNs. *Id.* at 327. Den Baas responded by assuring these officials that any such loss would be added to the value of the subsequent debt instruments, and would in turn be borne by AlliedSignal on liquidation of those instruments. But there could be no written agreement to this effect, explained den Baas, because "in that case it would not be a matter of a general partnership." *Id.*; Memo from den Baas to Jos Albers, 4/22/90, Joint Appendix

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[2] Petitioner acknowledges that ABN might have "had in mind a target return of LIBOR plus 75bp on the amount it invested," Petitioner's Initial Br. at 59, but argues that the Tax Court erred in finding that the parties actually entered into such an agreement. Petitioner points to the fact that AlliedSignal's payments were negotiated rather than specified in advance, and were not based on a LIBOR plus 75 basis points return. This dispute is, however, immaterial. See infra pp. 16-17.

("J.A.") 676. Den Baas nonetheless assured the authorities at ABN of his confidence that AlliedSignal would bear any such loss:

> [T]he fact that the client is the only one who is interested in such a sale and wants to obtain the installment note, whereby the SPCs have a right of veto during the entire procedure--as is, in fact, set forth in the partnership document--makes ABN NY Corporate Finance more than confident that the client will continue to have this loss charged to his account in the future as well.

Id. The loan-approving committees later authorized ABN's participation.

On April 19 ASA Investerings Partnership was formed. Tax Court Decision, 76 T.C.M. at 328. It consisted of AlliedSignal, AlliedSignal Investment Corporation ("ASIC"), a wholly-owned subsidiary of AlliedSignal, and the two SPCs, Barber Corp. N.V. and Domniguito Corp. N.V., which were controlled by foundations in turn controlled by ABN. Barber and Dominguito entered into revolving credit agreements with ABN. The foundations which owned the SPCs granted ABN an irrevocable option to buy shares of the respective SPCs at par value. *Id.*

On April 19th and 24th, the partners contributed a total of $850 million, with each partner receiving a partnership interest in accordance with its contribution. AlliedSignal's share was 10%, the SPCs' 90%. In May 1990, the parties supplemented their contributions (in the same ratio), bringing the total contribution to $1.1 billion.

On April 25, 1990 ASA purchased from two Japanese banks $850 million of 5-year floating rate notes which were not traded on an established securities market--the planned PPNs. *Id.* at 329. On May 8, the partnership met in Bermuda and decided to sell the PPNs for 80% cash and 20% LIBOR notes. *Id.* Between May 17 and May 24 (i.e., within one month of purchase), ASA sold the PPNs to two banks in exchange for a little under $700 million in cash and 11 notes. (With the cash it bought time deposits and 30-day commercial paper.) These notes each made 20 quarterly payments consisting of the 3-month LIBOR rate, calculated at the beginning of each payment period, applied to 25% of the notional principal amount, which in this case was $434,749,000. *Id.* The LIBOR notes did not require a return of principal at maturity; rather, the quarterly payments of interest on the "notional amount" can be seen as both interest and return of actual principal. ABN entered into swap transactions with Merrill, Barber and Dominguito to hedge ABN's interest rate risk relating to the LIBOR notes. Merrill also entered into swap transactions with the banks from whom it bought the LIBOR notes (as it had with the PPNs) to induce their participation. Merrill's transaction costs in selling the PPNs were $6.375 million. *Id.* This was added to the value of the LIBOR notes in ASA's partnership books, so that AlliedSignal would bear the costs of the sale when it acquired the LIBOR notes from the partnership. *Id.* at 329-330.

Because the LIBOR notes provided for 20 quarterly payments at a variable rate, and the PPNs were not sold on an established securities market, the sale of the PPNs qualified for use of the installment method. For the taxable year ending May 31, 1990, ASA recovered 1/6 of the basis in the PPNs (because the completion of the scheduled payout would occur in the sixth tax year after the sale, and reported $549,443,361 in capital gains (= $681,300,000 in cash minus

1/6($851,139,836)).[3] *Id.* at 331. The gain was allocated according to partnership interest, 90% to the SPCs and 10% to AlliedSignal and ASIC. *Id.*

On August 2, 1990, AlliedSignal issued $435 million in commercial paper, and with the proceeds purchased Barber's entire interest in ASA for about $400 million and a 13.43% interest in ASA from Dominguito for about $150 million. Between November 1991 and April 1992, ASA further reduced Dominguito's interest to 25%. AlliedSignal also paid a $4.4 million "premium" payment, representing a portion of the $5 million requested by den Baas. After this purchase, AlliedSignal and ASIC entered into several swaps with Merrill to hedge their interest in the LIBOR notes. *Id.* at 330. Between August 31 and September 28 AlliedSignal borrowed $435 million from ASA, using the proceeds to repay the debt incurred August 2; this indebtedness was paid off May 1, 1992.

On August 21 the partnership authorized a distribution of the LIBOR notes to AlliedSignal and ASIC, and about $116 million in cash and commercial paper to Dominguito. *Id.* at 331. During 1990, AlliedSignal and ASIC sold a fraction of the LIBOR notes with a basis of $246,520,807, for a total of $50,454,103, and reported a capital loss equal to the difference, $196,066,704. *Id.* That year, AlliedSignal also reported a capital gain of $53,926,336, its share of ASA's capital gain from the sale of the PPNs. *Id.*

On December 5, 1991, AlliedSignal made a direct payment of $1,631,250 to Dominguito, representing: the difference between ABN's funding costs and the SPCs' combined income allocations; interest on $92 million of ABN's funds that remained in ASA beyond the agreed upon date; and the difference (plus interest) between the $5 million up-front payment that ABN had requested and the $4.4 million it had previously paid. *Id.*

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[3] The parties stipulated in the Tax Court that ASA had erred in calculating the gain on its 1990 tax return and that the correct amount was $539,364,656.

Prior to liquidation, ABN and AlliedSignal agreed that ABN would refund $315,000, reflecting excesses of the SPCs' income allocations over funding costs, and of ASA's returns from November 22, 1991 through April 30, 1992 over LIBOR. *Id.* at 332. On June 1, 1992, the partners liquidated ASA. On November 31, AlliedSignal sold its remaining LIBOR notes for $33,431,000, and recovered the remainder of the basis, $429,655,738, taking a capital loss of $396,234,738. *Id.*

In a notice of final partnership administrative adjustment the Commissioner disallowed ASA's capital gain, reallocating it to AlliedSignal and ASIC and thus in substance cancelling out the tax losses otherwise enjoyed by AlliedSignal. *Id.* at 333. The Commissioner relied on alternative grounds: first, ASA was not a bona fide partnership, and Barber and Dominguito were not correctly deemed partners; and second, the transactions lacked "economic substance." *Id.*

* * *

The Tax Court agreed with the Commissioner that ASA was not a valid partnership for tax purposes, and thus did not reach the economic substance argument. At the outset, the court disregarded Barber and Dominguito "[f]or purposes of [its] analysis," Tax Court Decision, 76 T.C.M. at 333, finding that they were merely ABN's agents. First, they were thinly capitalized, and created just for purposes of the venture. Second, the parties themselves treated ABN as the partner, disregarding Barber and Dominguito. Third, Barber and

Dominguito were "mere conduits," to whom ABN lent funds and in whom ABN owned options to purchase shares for a de minimis amount.

Having found ABN to be the relevant party, the Tax Court turned its attention to the question whether AlliedSignal and ABN entered into a bona fide partnership. Although the Internal Revenue Code provides that "the term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on," 26 U.S.C. § 761, the court set out to determine whether the formal partnership had substance, quoting the Supreme Court's language in *Commissioner v. Culbertson*, 337 U.S. 733, 742 (1949), which said that the existence of the partnership (for tax purposes) would depend on whether, "considering all the facts . . . the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." Applying this test, the Tax Court concluded that AlliedSignal and ABN did not have "the requisite intent to join together for the purpose of carrying on a partnership." 76 T.C.M. at 335.

* * *

We review decisions of the Tax Court "in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury." 26 U.S.C. § 7482. Factual findings are reviewed for clear error, see *Commissioner v. Duberstein*, 363 U.S. 278, 291 (1960), and determinations of law de novo. See *United States v. Popa*, 187 F.3d 672, 674 (D.C. Cir. 1999). We have held that in tax cases mixed questions of law and fact are to be treated like questions of fact. See *Fund for the Study of Economic Growth and Tax Reform v. IRS*, 161 F.3d 755, 759 (D.C. Cir. 1998) (citing *Duberstein*, 363 U.S. at 289 n.11). Petitioner poses challenges to all three types of decisions constituting the Tax Court judgment.

Much of petitioner's opening brief is directed to an attack on the Tax Court's reasoning. We confess that some of that reasoning seems misdirected. For example, the court seemed to believe that because ABN and AlliedSignal had "divergent business goals," 76 T.C.M. at 333, they were precluded from having the requisite intent to form a partnership. We agree with petitioner that partners need not have a common motive. In fact, the desirability of joining complementary interests in a single enterprise is surely a major reason for creating partnerships. But we see no reason to think that this view, mentioned only in the opinion's initial summary and concluding paragraph, was essential to the court's conclusion.

Some of petitioner's argument seems an exercise in semantic ju jitsu. It argues that we may not consider whether the partnership was a "sham" because the Tax Court (a) explicitly refused to consider that, and (b) never used the word "sham." The first point is false, the second irrelevant. Although the Tax Court said that it would not consider whether the *transactions* at issue lacked "economic substance," *id.*, its decision rejecting the bona fides of the *partnership* was the equivalent of a finding that it was, for tax purposes, a "sham."

Getting to the controlling issue, petitioner argues that under the standard established in *Moline Properties, Inc. v. Commissioner,* 319 U.S. 436 (1943), the partnership cannot be regarded as a sham. The Court there said that a corporation remains a separate taxable entity for tax purposes "so long as [its] purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation." 319 U.S. at 439. The Tax Court has since applied *Moline* to partnership cases. See *Bertoli v. Commissioner,* 103 T.C. 501, 511-12 (1994).

Petitioner views *Moline* as establishing a two-part test, under which a tax entity is accepted as real if *either*: (1) its purpose is "the equivalent of business activity" (not tax avoidance), or (2) it conducts business activities. *Moline*, 319 U.S. at 439. Because ASA "engaged in more than sufficient business activity to be respected as a genuine entity," petitioner argues that ASA was a partnership under the second alternative. Petitioner's Reply Br. at 12. We agree if engaging in business activity were sufficient to validate a partnership ASA would qualify. It was infused with a substantial amount in capital ($1.1 billion), and invested it in PPNs, LIBOR notes, and other short-term notes over a period of two years. In fact, however, courts have understood the "business activity" reference in *Moline* to exclude activity whose sole purpose is tax avoidance. This reading treats "sham entity" cases the same way the law treats "sham transaction" cases, in which the existence of formal business activity is a given but the inquiry turns on the existence of a nontax business motive. See *Knetsch v. United States*, 364 U.S. 361, 364-66 (1960). Thus, what the petitioner alleges to be a two-pronged inquiry is in fact a unitary test--whether the "sham" be in the entity or the transaction--under which the absence of a nontax business purpose is fatal.[4]

Shortly after *Moline* the Second Circuit held per Judge Learned Hand in *National Investors Corp. v. Hoey*, 144 F.2d 466 (2d Cir. 1944), that the retention and sale of securities, after the date when the corporate holding had served its nontax goals, could not be considered for tax purposes. There an investment trust corporation proposed to merge with its subsidiaries. To this end it created a new corporation into which it transferred its interests in the subsidiaries in exchange for 10 shares of stock. But the stockholders decided to reject the plan to unify the four corporations. The investment trust then liquidated the new corporation, starting with an exchange of 10% of the new corporation's shares and taking a deduction based on the difference between the value of 10% of the shares when originally issued to the trust, and 10% of their reduced value a year later. In initiating even this 10% liquidation, however, it delayed for some time after the shareholders' vote. The court held that the trust was entitled to a deduction only for value decreases incurred from the time of the original transfer of assets to the corporation to "a reasonable time" after the stockholders rejected the plan. *Id.* at 468. Thereafter, "there was no longer any business for [the corporation] to do." *Id.* Retention of the corporation merely for the purpose of tax minimization was not enough. The court explicitly read the cases as saying that "the term 'corporation' will be interpreted to mean a corporation which does some 'business' in the ordinary meaning, and that escaping taxation is not 'business' in the ordinary meaning." *Id.* So too, for ASA: Although its investment in LIBOR notes might have had a business purpose, the prior three-week investment in and subsequent sale of PPNs was, like the retention of assets in *Hoey*, a business activity merely conducted for tax purposes.[5] Moreover, as discussed later, AlliedSignal's interest in any potential gain from the partnership's investments was in its view at all times dwarfed by its interest in the tax benefit.

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[4] Indeed, one might logically enough place the Tax Court's findings here under the "sham transaction" heading, viewing the formation of the partnership as the transaction. Because of the ultimate unity of the tests, however, there is no need to address this formulation.

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[5] The PPNs cost $850 million. When an expert was later engaged by AlliedSignal to evaluate the partnership's gains and losses, AlliedSignal asked that he assign to the LIBOR notes a value which, together with the cash, would bring the total value of the proceeds of the PPNs to $850 million. See J.A. 1343. AlliedSignal evidently did not believe that the initial investment in PPNs increased the return from the transactions in the aggregate.

The Ninth Circuit has similarly held that "business activity" is inadequate in the absence of a nontax business purpose. In *Zmuda v. Commissioner,* 731 F.2d 1417 (9th Cir. 1984), the taxpayers argued that the Tax Court incorrectly applied the "economic substance" rule rather than the "business purpose" rule. The court found that the taxpayer's argument "attempts to create a distinction where none exists. There is no real difference between the business purpose and the economic substance rules. Both simply state that the Commissioner may look beyond the form of an action to discover its substance." *Id.* at 1420. The court went on to say:

> The terminology of one rule may appear in the context of the other because they share the same rationale. Both rules elevate the substance of an action over its form. Although the taxpayer may structure a transaction so that it satisfies the formal requirements of the Internal Revenue Code, the Commissioner may deny legal effect to a transaction if its sole purpose is to evade taxation.

Id. at 1421. At issue was the validity of certain trusts, so the court's equation of the "transaction" test and the "entity" test was clearly a holding.

We note that the "business purpose" doctrine is hazardous. It is uniformly recognized that taxpayers are entitled to structure their transactions in such a way as to minimize tax. When the business-purpose doctrine is violated, such structuring is deemed to have gotten out of hand, to have been carried to such extreme lengths that the business purpose is no more than a facade. But there is no absolutely clear line between the two. Yet the doctrine seems essential. A tax system of rather high rates gives a multitude of clever individuals in the private sector powerful incentives to game the system. Even the smartest drafters of legislation and regulation cannot be expected to anticipate every device. The business purpose doctrine reduces the incentive to engage in such essentially wasteful activity, and in addition helps achieve reasonable equity among taxpayers who are similarly situated--in every respect except for differing investments in tax avoidance.

Thus the Tax Court was, we think, sound in its basic inquiry, trying to decide whether, all facts considered, the parties intended to join together as partners to conduct business activity for a purpose other than tax avoidance. Its focus was primarily on ABN, curiously. As we shall discuss later, the absence of a nontax business purpose was even clearer for AlliedSignal. Nonetheless, given ABN's protection from risk, and even from the borrowing costs of providing its capital contribution, there was no clear error in the finding that its participation was formal rather than substantive.[6] Petitioner alleges two primary ways in which the Tax Court erred in this regard.

First, petitioner says that the Tax Court incorrectly found that Barber and Dominguito were mere agents of ABN rather than partners in their own right. But this issue of classification makes no material difference. Once the court decided that the

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[6] Although petitioner argues that ABN's purpose was not tax-avoidance, but rather "included a desire to enhance its business relationship with AlliedSignal," Petitioner's Initial Br. at 41 n.19, the desire to aid another party in tax avoidance is no more a business purpose than actually engaging in tax avoidance.

SPCs were mere conduits for ABN, it shifted its focus to whether AlliedSignal and ABN (rather than the SPCs) formed a bona fide partnership. There was certainly no clear error in the court's view of the SPCs as being within the complete control of ABN, and there is no indication as to how the SPCs' intent as to the "partnership" differed from that of ABN.

Second, petitioner argues that the Tax Court erred by finding that ABN did not share in profits and losses because it received a specified return from AlliedSignal and hedged against risk through swap transactions with Merrill. On the profit side, we find no clear error in the court's findings that the direct payments made to ABN were to compensate it merely for its funding costs. Petitioner says that there was no explicit agreement that ABN would receive a return of LIBOR plus 75 basis points, pointing to the fact that the payments actually made by AlliedSignal to ABN did not produce such a return. See Petitioner's Brief at 59; *supra* note 2. But petitioner makes no argument that these payments were related to the success of the partnership's investments (i.e., the PPNs and LIBOR notes), and under the circumstances it is reasonable to infer that they were made pursuant to a pre-arranged agreement to compensate ABN for its funding costs (plus some amount above LIBOR, even if not 75 basis points).

Den Baas's testimony, moreover, confirms that ABN could make no profit from the transaction: any potential profit from the LIBOR notes would be offset by losses from the concomitant swap transactions. Petitioner cites *Hunt v. Commissioner,* 59 T.C.M. (CCH) 635 (1990), for the proposition that a guaranteed return is not inconsistent with partnership status. In *Hunt,* however, both parties had a bona fide business purpose for entering into the partnership, and unlike in the case at hand, the guaranteed return created a floor but not a ceiling. See *id*. at 648.

Turning to the risk of loss, we agree with the Tax Court that any risks inherent in ABN's investment were de minimis. As a preliminary matter, the court did not err by carving out an exception for de minimis risks, as no investment is entirely without risk. Unless one posited a particular asset (such as the dollar) as the sole standard, its value could change in relation to the values of other assets, and treating one--even the dollar--as the sole standard would be arbitrary. The Tax Court's decision not to consider ABN's "de minimis" risk is also consistent with the Supreme Court's view, albeit in the "sham transaction" context, that a transaction will be disregarded if it did "not *appreciably* affect [taxpayer's] beneficial interest except to reduce his tax." *Knetsch, 364 U.S.* at 366 (emphasis added) (quoting *Gilbert v. Commissioner,* 248 F.2d 399, 411 (2d Cir. 1957) (Hand, C.J., dissenting)).

There was no clear error in the Tax Court's determination that at no point during the transaction did ABN assume greater than de minimis risk. The PPNs were essentially risk free: not only were they issued by banks with the highest credit ratings but they were held for a mere three weeks. Moreover, because of the side agreement under which any loss on the PPNs would be embedded in the value of the LIBOR notes, AlliedSignal would bear any shortfall over the brief period in which PPNs were held. Petitioner argues that ABN was subject to the risk that AlliedSignal would ultimately decide not to acquire the LIBOR notes. This seems unlikely to the point of triviality, however, for two reasons: first, this step was integral to AlliedSignal's tax objective, and to the entire transaction; and second, at the point when the LIBOR notes would be distributed, Dominguito still owned over 40% of ASA, and according to the partnership agreement, any act of the partnership committee would require the consent of partners whose interest equaled or exceeded 95%. Nor was there any real hazard that AlliedSignal might agree to distribute the

LIBOR notes but refuse to make the adjustment for any loss on the PPNs: as den Baas had stated in a memorandum to ABN officials, the SPCs could counter by refusing consent for the distribution of the notes altogether.

The LIBOR notes certainly had greater inherent risk than the short-term PPNs; ABN, however, entered into hedge transactions outside the partnership to reduce the risk to a de minimis amount. In fact, the correlation between the swaps and the LIBOR notes was 99.999%, i.e., the company succeeded in hedging all but a de minimis amount of the risk associated with the LIBOR notes. Petitioner concedes that "the hedges provided the ABN parties with substantial protection from fluctuations in LIBOR Note value due to movements in interest rates." Petitioner's Reply Br. at 18. But ASA nevertheless contends that ABN still bore the credit risk associated with the issuers of the LIBOR notes and with Merrill, which provided the hedges. Once again, we find that the Tax Court correctly found the risk to be de minimis: the LIBOR notes were issued by banks having a credit rating of AAA and AA +, and were held by ASA for only three months. So too, the risk associated with the swaps with Merrill (a single-A rated institution) was de minimis. Finally, there was little, if any, risk associated with the commercial paper that ASA held at this point, which although unhedged, was found by the Tax Court to be "AAA-rated, short-term, and from multiple issuers." Tax Court Decision, 76 T.C.M. at 335.

Petitioner argues that ABN's side-transactions should not be considered in deciding whether a bona fide partnership was formed. It draws an analogy to a partnership which owns an uninsured building later destroyed by fire; this partnership is bona fide even if one partner had insured against his portion of the loss. The analogy, though imaginative, is not very telling. The insurance in the hypothetical is comparatively narrow, leaving a considerable range of potential business hazards and opportunities for profit. Contrast den Baas's observation at the outset of the present plan: "Credit risk: The structure demands that virtually no credit risk will be taken in the partnership since any defaults on the principal of the investments will jeopardize the objective .... Market interest rate risk: ABN New york [sic] will take care of perfect hedges in order to protect the bank from the changes in the value of the underlying securities .... due to interest rate fluctuations." J.A. 680-81. We note, moreover, that petitioner directs us to no evidence that ABN even bore the cost of these hedges. Given that Merrill, which had orchestrated the entire transaction and to whom AlliedSignal had paid a substantial sum, engaged in the swap transactions, it is likely that AlliedSignal assumed the costs of the swaps. A partner whose risks are all insured at the expense of another partner hardly fits within the traditional notion of partnership.

Petitioner argues that the Tax Court also erred in determining that ABN's capital contribution constituted a loan. We need not pass on this question because it is quite peripheral to the central issue of whether the parties entered into a bona fide partnership.

We noted earlier that the Tax Court's focus on ABN's intentions was a little puzzling. AlliedSignal, after all, was the driving force and AlliedSignal focused on tax minimization to the virtual exclusion of ordinary business goals. Of course no one wants to pay more than necessary, even for a very profitable tax minimization scheme, and the petitioner argues that even with the very substantial transaction costs associated with the partnership, AlliedSignal had grounds for expecting that it would come out more than $15 million ahead. As it proved, transaction costs were almost $25 million rather than the roughly $12 million it anticipated, Tax Court Decision, 76

T.C.M at 326, 332, so the ultimate financial gain, according to the parties, was actually about $3.6 million. The expected gain turned on the belief of Roger Matthews, AlliedSignal's assistant treasurer--which proved correct--that interest rates would shift in such a way that, when all the swaps were taken into account, AlliedSignal would benefit. But this evidence says nothing about AlliedSignal's use of the elaborate partnership--with a pair of partners concocted for the occasion. There is no reason to believe that AlliedSignal could not have realized Matthews's interest rate play without the partnership at far, far lower transactions costs. For the deal overall, the most telling evidence is the testimony of AlliedSignal's Chairman and CEO, who could not "recall any talk or any estimates of how much profit [the transaction] would generate." The Tax Court concluded that none of the supposed partners had the intent to form a real partnership, a conclusion that undoubtedly encompasses AlliedSignal. And the record amply supports that finding.

The decision of the Tax Court is

Affirmed.

T.C. Memo. 1998-305

UNITED STATES TAX COURT

ASA INVESTERINGS PARTNERSHIP,
ALLIEDSIGNAL INC., TAX MATTERS PARTNER, Petitioner
v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 27320-96. Filed August 20, 1998.

Jerome B. Libin, Steuart H. Thomsen, David A. Roby, Jr., William S. Corey, Robert S. Chase II, Alexa Temple Dubert, and H. Karl Zeswitz, Jr., for petitioner.

Jill A. Frisch, Anne O. Hintermeister, Leslie J. Spiegel, Peter J. Graziano, James M. Guiry, and Robert A. Baxter, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

FOLEY, Judge: Respondent issued ASA Investerings Partnership (ASA) a notice of final partnership administrative adjustment (FPAA) that reflected adjustments to ASA's partnership return for taxable years which ended on May 31, 1990, May 31, 1991, December 31, 1991, and June 1, 1992. On December 24, 1996, AlliedSignal Inc. (AlliedSignal), ASA's tax matters partner, petitioned the Court to redetermine respondent's adjustments to partnership items.

ASA was created by AlliedSignal, AlliedSignal Investment Corp., Barber Corp., N.V., and Dominguito Corp. N.V. The primary issue for decision is whether these corporations formed a valid partnership for Federal income tax purposes. We hold that they did not.

Unless otherwise indicated, section references are to the Internal Revenue Code in effect for the years in issue, and Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. On the date AlliedSignal filed the petition, ASA had no principal place of business because it had previously ceased operations.

I. AlliedSignal and the Merrill Lynch Proposal

AlliedSignal, a Delaware corporation, is a manufacturing company that produces aerospace and automotive products. It was formed in September 1985 when Allied Corp. merged with The Signal Companies, Inc.

In January 1990, AlliedSignal decided to sell its interest in Union Texas Petroleum Holdings, Inc. (UTP), an oil, gas, and petrochemical company. AlliedSignal expected to sell its interest before February 1991 and to realize a capital gain of approximately $446,700,000. Robert Luciano, a member of AlliedSignal's Board of Directors (the Board), informed AlliedSignal's Chief Financial Officer, John Barter, that Merrill Lynch & Co., Inc. (Merrill Lynch), an investment bank, had developed a tax proposal that could create capital losses to shelter AlliedSignal's anticipated capital gain. Mr. Luciano, who also served on Merrill Lynch's Board of Directors, further explained that he was associated with another corporation that had participated in a similar Merrill Lynch-designed transaction.

AlliedSignal decided to get more information about the proposal. In February 1990, E.S.P. Das, Merrill Lynch's Vice-Chairman of Investment Banking, and other Merrill Lynch representatives, described the plan to Roger Matthews, AlliedSignal's Assistant Treasurer, and other AlliedSignal representatives. The proposal, according to Merrill Lynch's representatives, included the following steps:

> 1. A partnership is formed by AlliedSignal with a foreign partner not subject to U.S. taxation.
>
> 2. The partnership is capitalized with cash contributions, primarily from the foreign partner, who would be the majority partner after the initial contributions.
>
> 3. The partnership purchases high-grade, floating-rate private placement notes (PPNs), which include put options, permitting the notes to be sold to the issuer at par.
>
> 4. The partnership sells the PPNs for consideration consisting of 80 percent cash and 20 percent LIBOR-indexed installment notes (LIBOR notes)[1].
>
> 5. The partnership reports the sale of the PPNs using the installment method under section 453. The gain is allocated according to each partner's partnership interest (i.e., the foreign partner recognizes most of the gain).

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[1] LIBOR (London Interbank Offering Rate) is the interest rate that most international banks dealing in Eurodollars charge each other for large loans. The contingent obligations are called LIBOR notes because payments are based on the product of LIBOR times a notional amount.

6. The partnership purchases high-grade financial instruments. Income on such instruments is allocated among the partners.

7. AlliedSignal buys a portion of the foreign partner's interest and becomes the majority partner.

8. The partnership distributes the LIBOR notes to AlliedSignal and cash to the foreign partner. AlliedSignal sells the LIBOR notes.

9. The partnership liquidates within 12 to 24 months of formation.

Merrill Lynch's representatives explained that the PPN sale could be reported pursuant to the installment sale rules. Under these rules, a small fraction of the PPNs' basis would be used to calculate the gain on the sale and the remaining basis would be allocated to the LIBOR notes. Thus, the PPN sale would create a large capital gain, and the LIBOR notes sale would create a large capital loss. The tax-exempt foreign partner would be allocated most of the capital gain, and AlliedSignal would realize the capital loss.

Merrill Lynch representatives further explained that the proposal was a package deal. Merrill Lynch would serve as the partnership's[2] financial adviser and, for a $7 million fee, recruit the foreign partner and arrange for the issuance and sale of the PPNs and LIBOR notes. To ensure a market for such issuance and sale, Merrill Lynch would structure and enter into the requisite swap transactions. Merrill Lynch would also serve as the partnership's financial intermediary, earning an additional $1,060,000 to $2,130,000 on the PPN sale and $212,000 to $425,000 on the LIBOR note sale. The foreign partner, for its participation in the transaction, would charge AlliedSignal the greater of $2,850,000 or 75 basis points (b.p.)[3] on funds advanced to the partnership. In addition, AlliedSignal would pay all of the partnership's expenses. Merrill Lynch estimated that AlliedSignal's total expenses for the entire venture[4] would be between $11,300,000 and $12,600,000.

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[2] We refer to ASA as a "partnership" and AlliedSignal, ABN, ASIC, Barber, and Dominguito as "partners". These terms are used for convenience and are not intended to have any legal significance.

In March 1990, G. Peter D'Aloia, AlliedSignal's Treasurer and Vice President of Taxes, and Mr. Barter, presented the plan to Edward Hennessy, AlliedSignal's Chairman and CEO. Mr. Barter and Mr. D'Aloia recommend that Mr. Hennessy approve the plan because of its tax advantages. Mr. Hennessy decided that the proposal should be presented at the Board's April 30, 1990, meeting and that prior to such meeting the Board's Executive Committee should consider the proposal. On April 16, 1990, the Board's Executive Committee convened, and Mr. D'Aloia described the proposal and its essential steps. Although the foreign partner's identity had not yet been revealed to AlliedSignal, the executive committee approved the proposal and an initial $110 million contribution. Two weeks later, after a brief presentation of the proposal's potential tax benefits, the Board approved the venture.

II. Algemene Bank Netherlands N.V.

Prior to April 16, 1990, Mr. Matthews was concerned that the venture's success would depend on the post-formation decisions of a foreign partner whose identity had not yet been revealed to AlliedSignal. When he expressed this concern to Merrill Lynch, Mr. Das assured him that the foreign partner would be an AA- or AAA-rated international bank that would participate in the venture at AlliedSignal's direction. Although AlliedSignal had not yet been told, Merrill Lynch had already chosen Algemene Bank Netherlands N.V. (ABN) to serve as the foreign partner.

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[3] One basis point is equal to 1/100th of 1 percent.

[4] We refer to the entire series of transactions as the "venture". This term is used for convenience and is not intended to have any legal significance.

ABN, one of The Netherlands' largest commercial banks, had participated in several similar Merrill Lynch-designed transactions. ABN and AlliedSignal already had a lending relationship, but ABN believed it could strengthen that relationship by participating in the venture and being a compliant partner.

Mr. Johannes den Baas, Vice President of Corporate Finance for ABN New York, an ABN affiliate, was responsible for getting the venture approved. In seeking such approval, Mr. den Baas followed ABN's standard procedures for processing loans in excess of $25 million. Accordingly, the transaction was processed through and approved by ABN's North American Credit Committee, Foreign Credit Department, and headquarters.

On April 5, 1990, Mr. den Baas sent ABN's Risk Management Division a memorandum, credit proposal, and AlliedSignal's financial statements. He requested authorization to enter into the venture with AlliedSignal, form two corporations, and lend $990 million to these corporations. The corporations would contribute the $990 million to the venture. Realizing that ABN officials would be concerned about repayment dates, he attached to the credit proposal the following "calendar of events":

> First week of August [1990], Allied Signal Inc. will purchase $490mm. of the * * * [corporations'] interests directly reducing ABN's involvement to $500mm.
>
> First week of December 1990, the * * * [corporations'] interest will be further reduced by $300mm., either by direct buy-down or distribution of assets from the partnership, to $200mm.
>
> First week of May 1992, the * * * [corporations] will be taken out of the partnership fully.

Mr. den Baas described the purpose of the transaction as "the same as all the other Curacao based partnerships". The memorandum further stated:

> AlliedSignal Inc. has a capital gain tax liability and this will cure their liability.
>
> The remuneration will be 30 bps. on the loan * * * to the * * * [corporations] plus a fee directly from Allied Signal Inc. to ABN New York representing an additional 45 bps. over the outstanding amounts bringing the total to 75 bps. over LIBOR. Furthermore Allied Signal Inc. will make ABN whole for the difference between * * * [commercial paper] and LIBOR * * * upfront. The net income will be $5.5mm. received partly over time in the loan and partly in fees from Allied Signal Inc.

ABN knew that the partnership's income allocations alone would not provide the requisite return (i.e., 75 b.p. over LIBOR on funds transferred to the partnership). AlliedSignal would have to supplement these allocations with direct payments to ABN. As Mr. den Baas stated in another internal memorandum:

> Since the * * * [partnership] structure itself will not carry the possibilities for * * * [a return of 70-80 b.p. over LIBOR], income will be received by ABN New York in upfront payments made by * * * [AlliedSignal].

Although generally comfortable with the venture, ABN officials expressed concern regarding a potential loss relating to the sale of the PPNs. In an April 22, 1990, memorandum, Mr. den Baas assured them that any such loss would be added to the value of the LIBOR notes and, ultimately, borne by AlliedSignal when the LIBOR notes were distributed to it. ABN officials wanted this arrangement included in the partnership agreement but Mr. den Baas explained that a written agreement was not feasible:

> Of course, this arrangement cannot be included in the documentation since in that case it would not be a matter of a general partnership. Even a side letter would seriously weaken this position. * * *

Mr. den Baas further explained that if AlliedSignal reneged on its promise to bear any loss relating to the sale, ABN would not allow the partnership to distribute the LIBOR notes to AlliedSignal. After receiving these and other assurances, the loan-approval committees authorized ABN's participation in the venture.

III. Formation of ASA

A. The Bermuda Agreement

In Bermuda, on April 17 and 18, 1990, Mr. Matthews, Mr. den Baas, and Peter H. de Beer, Deputy Managing Director of ABN Trust Company Curacao N.V. (ABN Trust), an ABN affiliate, met together for the first time. Prior to this meeting, Merrill Lynch carefully explained the proposal to both ABN's and AlliedSignal's representatives. As a result, all parties entered the meeting with a detailed understanding of the venture and their respective obligations. The negotiations between AlliedSignal and ABN focused on ABN's expected return and the venture's transaction costs. These negotiations culminated in various agreements, which we refer to collectively as "the Bermuda Agreement".

Mr. Matthews and Mr. den Baas agreed that AlliedSignal would pay all of the partnership's expenses and that AlliedSignal would pay ABN a return, which we refer to as ABN's "specified return", equal to ABN's funding costs (i.e., approximately LIBOR) plus 75 b.p. on funds advanced to the partnership. ABN's specified return consisted of income allocations, and AlliedSignal's direct payments, to ABN. In essence, the direct payments would equal the difference between the specified return and the income allocations. The precise amount of specified return would depend on the amount of ABN funds held by the partnership and the amount of time that the partnership held such funds. AlliedSignal and ABN also agreed that ABN would receive partial repayment during the partnership's existence (i.e., August 1990 and March 1991) and full repayment by May 1992.

Mr. den Baas wanted AlliedSignal to pay "up-front" $5 million of the specified return. Mr. Matthews, however, wanted to delay the payment as long as possible to ensure

ABN's adherence to the venture's scheduled steps. Mr. den Baas and Mr. Matthews discussed various ways to characterize and structure AlliedSignal's direct payments to ABN. Ultimately, they decided to characterize some of these payments as "premiums". They further agreed that these premium payments would be made upon the occurrence of certain events.

B. Structure and Funding of ASA

On April 18, 1990, AlliedSignal formed AlliedSignal Investment Corp. (ASIC), a wholly owned subsidiary. On the same day, Barber Corp. N.V. (Barber) and Dominguito Corp. N.V. (Dominguito) were formed. Each corporation was owned by two Netherlands Antilles foundations controlled by ABN Trust: Barber was owned by the Demian Foundation and the Freya Foundation, while Dominguito was owned by the Aida Foundation and the Carmen Foundation. Each foundation contributed $3,000 to its corporation in exchange for 3,000 shares with a par value of $1 per share. Thus, Barber, and Dominguito were each capitalized with $6,000.

Barber, Dominguito, and ABN entered into revolving credit agreements that provided for Barber and Dominguito to pay ABN interest of LIBOR plus 30 b.p. on the loans. These loans would be secured by the stock held by the foundations and, thus, indirectly by Barber's and Dominguito's partnership interests. Barber, Dominguito, and ABN also entered into subordinated loan agreements that provided for interest-free loans from ABN to Barber and Dominguito. In addition, each foundation granted ABN an irrevocable option to acquire, at par value, the shares of the respective corporation that each foundation owned.

On April 19, 1990, AlliedSignal, ASIC, Barber, and Dominguito formed ASA as a partnership under New York law. In April and May 1990, they transferred a total of $1,100,000,000 to ASA. The following chart delineates the amount of funds transferred by each partner:

	Amount Transferred to ASA	Percentage Interest in ASA
AlliedSignal	$99,000,000	9
ASIC	11,000,000	1
Dominguito	594,000,000	54
Barber	396,000,000	36

The funds that Barber and Dominguito transferred to ASA had been borrowed from ABN pursuant to their respective revolving credit agreements.

C. The Partnership Agreement

On April 18, 1990, the partners executed the ASA partnership agreement. The partnership agreement did not incorporate the Bermuda Agreement but provided guidance in the following areas:

> Purpose: ASA would be organized:
>
> for the object and purpose of making investments in notes, bonds, debentures, and other interest bearing instruments, owning, managing and supervising such investments, sharing the profits and losses therefrom, and engaging in such activities necessarily incidental or ancillary thereto. The Partnership is also being organized to enable * * * [AlliedSignal and ASIC] to reduce their credit risk exposure on investments while obtaining a yield in excess of what they could obtain from U.S. treasury securities and to enable * * * [Barber and Dominguito] to earn a rate of return

> in excess of the rate available on direct investments in the securities which the Partnership plans to purchase.

Management: ASA would be governed by a partnership committee, consisting of Mr. Matthews, representing AlliedSignal and ASIC, and Mr. de Beer, representing Barber and Dominguito. An act of the partnership committee generally would require the consent of partners whose partnership percentages totaled at least 95 percent.

Income Allocations: Generally, ASA's net income would be allocated as follows: If the combined capital of Barber and Dominguito exceeded 50 percent of the capital of all the partners, income would be allocated first to AlliedSignal and ASIC in an amount limited to their invested capital multiplied by the 90-day Treasury bill rate plus 10 b.p., then to Barber and Dominguito in an amount limited to their invested capital multiplied by LIBOR plus 1 b.p., and the balance to each partner in proportion to its respective partnership interest. If Barber's and Dominguito's combined capital did not exceed 50 percent, net income would be allocated in proportion to each partner's interest.

Loss Allocations: Generally, ASA's losses would be allocated to each partner in proportion to its respective partnership interest. Any loss attributable to the bankruptcy of an issuer of a debt instrument, however, would be allocated as follows: If the combined capital of Barber and Dominguito exceeded 50 percent of the capital of all the partners, loss would be allocated first to Barber and Dominguito to the extent of the positive balance in their book capital accounts; then to AlliedSignal and ASIC to the extent of the positive balance in their book capital accounts; and the balance to each partner in proportion to its respective partnership interest. If Barber's and Dominguito's combined capital accounts did not exceed 50 percent, such loss would be allocated in proportion to each partner's interest.

Capital Contributions: No interest would be paid on any capital contributions to the partnership, and capital accounts would be maintained in accordance with section 1.704-1(b), Income Tax Regs.

D. Miscellaneous ASA Matters

ASA engaged Merrill Lynch as its financial adviser (e.g., Merrill Lynch calculated the value of ASA's investments) and N.V. Fides, a Netherlands Antilles affiliate of ABN, as its investment adviser. The Curacao office of N.V. Fides was the principal office of ASA, and all of ASA's business was to be conducted at such office. Pursuant to authorization from N.V. Fides, ABN opened the "ASA Investerings Partnership Custody Account" at ABN New York's office and placed ASA's commercial paper in ABN New York's vault at Bankers Trust. ASA adopted a fiscal year ending on May 31 (i.e., consistent with Dominguito's, the majority partner's, fiscal year).

IV. ASA's Transactions

A. Purchase of PPNs

On April 25, 1990, ASA purchased $850 million of 5-year PPNs with put options exercisable on November 20, 1991. Of these PPNs, $350 million were issued by the Long Term Credit Bank of Japan (LTCB) and rated AA by Standard and Poor's. The remaining $500 million of PPNs was issued by Sumitomo Bank Capital Markets, Inc. (Sumitomo), and rated AA+ by Standard & Poor's.

Merrill Lynch induced LTCB to issue the PPNs by arranging basis swaps (i.e., the exchange of payments based on one variable interest rate for payments based on another variable interest rate) that converted LTCB's cost of capital for issuing the PPNs to an attractive sub-LIBOR interest rate. These swaps provided that Merrill Lynch would pay LTCB an amount equal to the coupon rate of the LTCB PPNs. In exchange, LTCB paid Merrill Lynch a sub-LIBOR rate on the face amount of the PPNs.

B. Sale of PPNs and Acquisition of LIBOR Notes

On May 8, 1990, the ASA partnership committee met in Bermuda and adopted a resolution authorizing and directing the sale of the PPNs for consideration consisting of approximately 80 percent cash and 20 percent LIBOR notes. Between May 17 and 24, 1990, ASA sold the PPNs to Mitsubishi Bank, Ltd. (Mitsubishi) and Banque Francaise du Commerce Exterieur (BFCE). Standard and Poor's rated Mitsubishi AA+ and BFCE AAA. In exchange for the PPNs, ASA received $681,300,000 and 11 LIBOR notes. ASA used the $681,300,000 to purchase time deposits and 30-day commercial paper.

The LIBOR notes had a total notional principal amount of $434,749,000. Each of the 11 LIBOR notes required 20 quarterly payments of an amount equal to 3-month LIBOR (i.e., determined at the beginning of each payment period) multiplied by approximately 25 percent of the note's notional principal amount. Payments were to commence on August 31, 1990, and end on May 31, 1995.

ABN entered into a complex series of Merrill Lynch-designed swap transactions involving itself, Barber, Dominguito, and Merrill Lynch. These swaps fully hedged ABN's interest rate risk relating to the LIBOR notes. Merrill Lynch also structured and entered into swap transactions with Mitsubishi and BFCE to induce their participation in the venture.

1. Cost of Selling the PPNs

Merrill Lynch initially told AlliedSignal that the sale of the PPNs would cost between $1,060,000 and $2,130,000. On April 13, 1990, 3 days before the executive committee meeting, Merrill Lynch told AlliedSignal that the PPN sale would cost approximately $4,250,000. Merrill Lynch ultimately imposed a cost of $6,375,000 on the PPN sale. This cost was imposed through a reduction in the value of the consideration received by ASA (i.e., the $434,749,000 notional principal amount of the LIBOR notes would have been greater without the cost). Merrill Lynch valued the LIBOR notes at $163,931,068, which was calculated as follows:

Face Amount	$850,000,000
Less:	
75 b.p. cost	(6,375,000)
Net Amount	843,625,000
Plus:	
Accrued Interest	1,606,068
Less: Cash	(681,300,000)
Value	163,931,068

On its partnership books, ASA recorded the LIBOR notes' value at $170,306,068 (i.e., adding $6,375,000, attributable to the cost of the PPN's sale, to the $163,931,068 fair market value of the LIBOR notes).

2. Installment Sales Reporting

Because the LIBOR notes provided for 20 quarterly payments that varied with LIBOR, ASA could not determine the PPNs' aggregate selling price by the end of its May 31, 1990, taxable year. Pursuant to section 15A.453-1(c), Temporary Installment Sales Regs., 46 Fed. Reg. 10711 (Feb. 4, 1981), ASA used the installment method for contingent payment sales to report the sale of the PPNs. This regulation provides for the ratable allocation of basis over the term of a fixed-term contingent obligation.

For the taxable year ending May 31, 1990, ASA recovered $141,856,639 (i.e., 1/6) of its reported $851,139,836 basis in the PPNs and reported $539,443,361 of capital gain on the sale (i.e., $681,300,000 minus $141,856,639). The gain was allocated among the partners as follows:

	Percentage Interest in ASA	Gain
ASIC	1	$5,394,434
AlliedSignal	9	48,531,902
Barber	36	194,199,610
Dominguito	54	291,299,415
Total	100	539,425,361

The installment payments would be received on the LIBOR notes over 5 additional partnership taxable years (i.e., May 31, 1991, through May 31, 1995).

V. AlliedSignal Purchases Majority Interest in ASA

On August 2, 1990, AlliedSignal issued $435 million of commercial paper. On the same day AlliedSignal purchased an additional interest in ASA for $545 million. AlliedSignal purchased 36 percent of ASA from Barber for $397,438,000 and 13.43 percent of ASA from Dominguito for $147,562,000. The $545 million AlliedSignal paid consisted of a $540,600,000 payment equal to the value of Barber's and Dominguito's interest (i.e., 49.43 percent of $1,093,657,933) and a $4,400,000 premium payment. AlliedSignal paid the $4,400,000 to compensate for the shortfall between ABN's specified return and Barber's and Dominguito's income allocations. After these purchases, the ASA interests held by AlliedSignal, ASIC, Barber, and Dominguito were 58.43 percent, 1 percent, 0 percent, and 40.57 percent, respectively.

In anticipation of AlliedSignal's purchase, ASA revalued its assets at $1,093,657,933. This value included the LIBOR notes valued at $163,964,000. The value of the LIBOR notes reflected a $6,342,068 decrease in value since their acquisition and included $6,375,000 attributable to the cost of selling the PPNs.

After the August 2 purchase, AlliedSignal and Merrill Lynch entered into five swaps designed to hedge AlliedSignal's and ASIC's combined 59.43 percent interest in the LIBOR notes. Swaps one through four were designed to eliminate the yield curve risk (i.e., the risk from the movement of long-term, relative to short-term, interest rates). These swaps required AlliedSignal to pay Merrill Lynch, on a quarterly basis, a fixed rate times various notional principal amounts in exchange for quarterly payments of 3-month LIBOR on those same amounts. The fifth swap required AlliedSignal to make quarterly payments of 3-month LIBOR times a certain notional principal amount, in exchange for quarterly payments of a fixed rate times the same notional principal amount.

Between August 31 and September 28, 1990, AlliedSignal borrowed $435 million from ASA by issuing ASA $435 million of short-term notes (AlliedSignal Short-Term Notes). These notes had a maturity date of December 28, 1990, a money-market yield, and put and call options exercisable at par on a monthly basis. AlliedSignal used proceeds from the loan to extinguish the commercial paper it had issued on August 2, 1990. AlliedSignal and ASA, in a series of extensions, changed the maturity of the AlliedSignal Short-Term Notes from December 28, 1990, to December 31, 1993.

VI. ASA Distributes the LIBOR Notes to AlliedSignal

On August 21, 1990, the ASA partnership committee met in Bermuda and authorized a distribution of assets. The minutes of this meeting state:

> The Representative of Dominguito Corporation N.V. expressed concern over the volatility of the investments. He stated that Dominguito would prefer cash in any distribution from the Partnership. The Representative of Allied-Signal Inc. and Allied-Signal Investment Corporation voiced his opinion that they expected favorable interest rate fluctuations. He stated that they would prefer to receive Installment Purchase Agreements in any distribution of assets of the Partnership.

Following this meeting, ASA distributed $167,469,860 of LIBOR notes to AlliedSignal, $2,866,140 of LIBOR notes to ASIC, and $116,279,033 in cash and commercial paper to Dominguito.

For purposes of the distribution, ASA valued the LIBOR notes at $170,336,000. The value of the LIBOR notes reflected a $6,372,000 increase in value since August 2, 1990, and included $6,375,000 attributable to the cost of selling the PPNs. The distribution of LIBOR notes resulted in AlliedSignal bearing the entire $6,375,000 cost of selling the PPNs (i.e., such cost was embedded in the value of the LIBOR notes). In addition, AlliedSignal's and ASIC's combined interest in the LIBOR notes increased from an approximately 60-percent indirect interest to a 100-percent direct interest.

AlliedSignal determined that the LIBOR notes' basis was $709,283,197, computed as follows:

Initial Cost Basis		1/6 of Cost Basis Allocated to 5/31/90 FYE		Computed Basis on Distribution
$851,139,836	-	$141,856,639	=	$709,283,197

AlliedSignal determined that $697,348,518 of this basis should be allocated to the LIBOR notes it received and $11,934,677 to the LIBOR notes ASIC received.

VII. AlliedSignal Sells A Portion of the LIBOR Notes

During 1990, AlliedSignal and ASIC sold LIBOR notes for a total of $50,454,103. The following chart delineates these sales:

Date	Purchaser	Basis As Reported By AlliedSignal	Sale Price
9-06-90	Unibank A/S	$82,599,556	$17,502,543
11-16-90	Generale Bank	82,843,620	17,129,250
11-30-90	Unibank A/S	81,077,631	15,822,310
Total		246,520,807	50,454,103

AlliedSignal determined that these LIBOR notes had a total basis of $246,520,807. Accordingly, on its 1990 Federal income tax return, AlliedSignal reported $196,066,704 of capital losses (i.e., $50,454,103 minus $246,520,807) relating to the sale of the LIBOR notes and a capital gain of $53,926,336 relating to the sale of the PPNs. AlliedSignal filed a Form 1139 claiming a $27,151,087 refund in 1987 attributable to a $181,628,283 net capital loss carryback (i.e., some of which was attributable to other capital gains and losses AlliedSignal incurred in 1990). After the 1990 LIBOR note sale, ASIC held no LIBOR notes and AlliedSignal held LIBOR notes with a total notional principal amount of $280,810,000. The total cost of selling the LIBOR notes was $6,110,000, rather than Merrill Lynch's initial estimate of less than $500,000.

Merrill Lynch structured and entered into swap transactions that transferred the interest rate risk of the LIBOR notes from Generale Bank and Unibank A/S to Merrill Lynch. These swaps were an effective inducement for the banks to buy the LIBOR notes. On November 9, 1990, AlliedSignal entered into its sixth swap with Merrill Lynch to further hedge its interest rate risk relating to its LIBOR notes. After this swap was in place, AlliedSignal was hedged on 94 percent of its LIBOR notes. On November 13, 1990, AlliedSignal purchased 5-year Treasury futures to lock in interest rates on the LIBOR notes it intended to sell later that month.

VIII. Dominguito's Partnership Interest Is Reduced

On November 22, 1991, ASA redeemed 7.57 percent of Dominguito's interest for $91,898,434. The redemption reduced Dominguito's interest to 33 percent and increased AlliedSignal's and ASIC's respective interests to 65.87 and 1.13 percent.

Throughout the venture, AlliedSignal and ABN carefully calculated the shortfall between ABN's specified return and Barber's and Dominguito's income allocations. On its 1990 financial records, AlliedSignal recorded the shortfall as an accrued liability, thereby treating the amount as a present obligation. On December 5, 1991, after calculating a shortfall, AlliedSignal paid ABN $1,631,250. The payment consisted of: $765,147 (i.e., the difference between ABN's funding cost and Barber's and Dominguito's combined income allocations); $231,250 (i.e., interest on $92 million of ABN funds that remained in ASA until November, rather than March 1991, as had been established in the Bermuda agreement); and $634,853. The $634,853 payment was the difference between the $5 million ABN requested that AlliedSignal pay "up-front" and the $4,400,000 AlliedSignal paid on August 2, 1990, plus interest. AlliedSignal and ABN had considered making this payment in the form of a "consulting fee", but they ultimately decided against this characterization.

On April 8, 1992, ASA redeemed 8 percent of ASA from Dominguito for $76,961,863. After the distribution, the ASA interests held by AlliedSignal, ASIC, and Dominguito were 73.74 percent, 1.26 percent, and 25 percent, respectively.

IX. ASA Is Liquidated

During April and May 1992, AlliedSignal representatives and Mr. den Baas discussed ABN's specified return and the liquidation of ASA. Mr. den Baas provided AlliedSignal with a schedule comparing Barber's and Dominguito's income allocations. The schedule indicated that from November 22, 1991, through April 30, 1992, Barber's and Dominguito's income allocations exceeded ABN's funding costs by $152,162. AlliedSignal prepared several analyses regarding ABN's return. Some of these analyses included a determination of what ABN's return would have been if AlliedSignal had made a $5 million payment "up-front" and if all of Dominguito's interest in ASA had been redeemed by May 1992. Based upon these analyses, AlliedSignal suggested that ABN pay AlliedSignal $225,741, plus the $152,162 set forth in ABN's schedule. Ultimately, ABN agreed to pay AlliedSignal $315,000.

On May 1, 1992, ASA tendered the AlliedSignal Short-Term Notes to AlliedSignal, in return for a payment of $435 million plus accrued interest of $1,646,522. On the same day, ASA purchased newly issued 30-year AlliedSignal notes (the AlliedSignal Long-Term Notes). The AlliedSignal Long-Term Notes had a $480 million total notional principal amount and a 9.23 percent interest rate. On May 20, 1992, ASA exchanged the AlliedSignal Long-Term Notes for all the stock of ASA

Investments, Inc., a wholly owned subsidiary of ASA, which was formed to participate in the liquidation of ASA.

On May 28, 1992, ASIC was liquidated into AlliedSignal and its 1.26 percent ASA interest was transferred to AlliedSignal, leaving AlliedSignal and Dominguito as ASA's remaining partners (i.e., AlliedSignal owned 75 percent and Dominguito owned 25 percent).

On June 1, 1992, representatives of AlliedSignal and Dominguito met in Bermuda and liquidated ASA. They allocated $2.3 million of accrued interest on the AlliedSignal Long-Term Notes to AlliedSignal; allocated $624,741 of ASA's income to Dominguito; and transferred $315,000, as previously agreed, from Dominguito's capital account to AlliedSignal's capital account. Upon liquidation, AlliedSignal received $3,756,307 and all the stock of ASA Investments, Inc., and Dominguito received $150,995,457 and a $10 million MCA Funding Corp. note.

X. Barber and Dominguito Are Liquidated

After AlliedSignal's August 1990 purchase of Barber's interest, ABN exercised its options to acquire, from the Demian and Freya foundations, Barber's shares at par (i.e., $6,000). Barber immediately declared a dividend in the amount of its remaining earnings and current profits. Three days later, the Demian and Freya foundations reacquired these shares and liquidation proceedings subsequently commenced. Similarly, following the liquidation of ASA, ABN acquired the amount received from the liquidation of Dominguito's ASA interest.

XI. AlliedSignal Sells the Remaining LIBOR Notes

On September 28, 1992, UTP redeemed all of AlliedSignal's preferred stock and warrants for $355 million. On November 18, 1992, in a secondary public offering, AlliedSignal tendered all of its UTP common stock for $585 million. Thus, AlliedSignal disposed of its entire interest in UTP for a total of $940 million.

On November 30, 1992, AlliedSignal sold its remaining LIBOR notes to BFCE for $33,431,000. AlliedSignal calculated a basis of $429,665,738 for these notes and on its 1992 Federal income tax return, reported a capital loss of $396,234,738 on the sale. AlliedSignal also reported a capital gain of $264,667,000 on the sale of its UTP interest. After taking account of other capital gains and losses, AlliedSignal had a net capital loss of $144,741,887.

XII. Contribution, Distribution, and Expense Summary

AlliedSignal and ASIC contributed $110 million to ASA and purchased Barber's and Dominguito's ASA interests for $540,600,000 (i.e., a total investment of $650,600,000) and ultimately received distributions from ASA totaling $712,678,500. AlliedSignal made direct payments to Barber, Dominguito, and ABN totaling $5,716,250; paid $47,872,343 in interest on the loan from ASA; received $40,983,490 from its swap transactions; and paid $24,783,800 of expenses relating to transaction costs (i.e., attributable to the sale of the PPNs and LIBOR notes) and various fees (i.e., Merrill Lynch's legal, accounting, and various financial services fees).

Barber and Dominguito collectively contributed $990 million to ASA and ultimately received $1,046,720,226. The $1,046,720,226 consisted of: $540,600,000 from AlliedSignal's August 2, 1990, purchase of all of Barber's, and a portion of Dominguito's, interests; $168,860,297 from redemptions of Dominguito's interest; $331,543,679 in income and property distributions to Barber and Dominguito; and $5,716,250 in direct payments from AlliedSignal to Barber, Dominguito, and ABN. ABN ultimately received all payments to Barber and

Dominguito. In addition, ABN received $5,851,355 from its swap transactions.

XIII. Respondent's Determinations

On September 27, 1996, respondent issued the FPAA. In the FPAA, respondent disallowed the capital gain, portfolio income, portfolio expenses, and a portion of the basis in the LIBOR notes reported by ASA. Respondent reallocated 90 percent of such items to AlliedSignal and 10 percent of such items to ASIC.

In the FPAA, respondent contends that ASA is not a valid partnership and that Barber and Dominguito are not partners. As an alternative position, respondent contends that the transactions lack economic substance. Respondent further states that if this contention is sustained, "no gain will be realized or recognized upon the sale of the * * * [PPNs]." Accordingly, the primary issue is whether Barber and Dominguito are partners with AlliedSignal and ASIC.[5]

OPINION

I. Applicable Law

The Internal Revenue Code provides that a partnership includes "a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on". Secs. 761(a); 7701(a)(2). The existence of a valid partnership depends on whether:

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[5] Because we agree with respondent's primary contention, we need not decide the economic substance issue. Cf. ACM Partnership v. Commissioner, T.C. Memo. 1997-115 (addressing the economic substance issue in a similar transaction).

> considering all the facts--the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent--the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.

Commissioner v. Culbertson, 337 U.S. 733, 742 (1949); Maiatico v. Commissioner, 183 F.2d 836, 838 (D.C. Cir. 1950), remanding 12 T.C. 196 (1949).

II. The Parties

For purposes of our analysis, we disregard Barber and Dominguito. The following facts demonstrate that Barber and Dominguito were ABN's agents. Cf. Commissioner v. Bollinger, 485 U.S. 340 (1988). First, Barber and Dominguito were thinly capitalized shell corporations established for the sole purpose of engaging in the venture. Second, the parties treated ABN as the real participant in the venture and disregarded Barber's and Dominguito's respective corporate forms (e.g., AlliedSignal, on December 5, 1991, paid ABN $1,631,250 for Barber's and Dominguito's participation in the venture). Third, Barber and Dominguito were mere conduits. ABN lent Barber and Dominguito the funds for their respective "capital contributions" and retained options that allowed ABN to purchase Barber's and Dominguito's share for a de minimis amount. Indeed, Mr. den Baas testified that eventually all Barber's and Dominguito's profit "would come back" to ABN. Similarly, because ASIC is AlliedSignal's wholly owned subsidiary, we consider AlliedSignal, not ASIC, the relevant party. Therefore, the issue is whether AlliedSignal and ABN intended to join together in the present conduct of an enterprise.

III. Joint Undertaking of an Enterprise

To form a valid partnership, AlliedSignal and ABN must have intended to join together in the present conduct of an enterprise. Commissioner v. Culbertson, supra at 742. Petitioner contends that AlliedSignal and ABN joined together for the common purpose of investing in interest bearing instruments and sharing the profits and losses therefrom. We disagree for reasons that we summarize here and explain at greater length below.

AlliedSignal and ABN had divergent business goals. AlliedSignal entered into the venture for the sole purpose of generating capital losses to shelter an anticipated capital gain. In pursuing this goal, AlliedSignal chose to ignore transaction costs, profit potential, and other fundamental business considerations. In fact, AlliedSignal's Board and the Board's Executive Committee focused only on potential tax benefits when they approved the plan.

In contrast, ABN entered into the venture for the sole purpose of receiving its specified return. This return was independent of the performance of ASA's investments (e.g., the profitability of the LIBOR notes) and the success of the venture (i.e., whether AlliedSignal succeeded in generating capital losses). Moreover, as will be explained, ABN did not have any profit potential beyond its specified return and did not have any intention of being AlliedSignal's partner. In essence, we agree with Justice Frankfurter's statement that if an arrangement does not put all parties "in the same business boat, then they cannot get into the same boat merely to seek * * * [tax] benefits". Commissioner v. Culbertson, supra at 754 (Frankfurter, J., concurring).

IV. Partnership Formalities

Petitioner contends that ASA is a bona fide partnership because the purported partners carefully followed partnership formalities. Such formalities may have created a partnership facade, but the conduct of AlliedSignal and ABN demonstrates that the Bermuda Agreement, not the partnership agreement, governed their affairs.

A. Income Allocations

The partnership agreement provided that ASA's income would be allocated pursuant to a formula. The income allocations, however, were merely an artifice to pay ABN's specified return. AlliedSignal subtracted ABN's income allocations from the specified return and made up the difference with direct payments.

On August 2, 1990, AlliedSignal made the first direct payment to ABN--$4,400,000. The $4,400,000 was credited towards ABN's specified return. On December 5, 1991, AlliedSignal paid ABN an additional $1,631,250, which also was calculated to pay a portion of such return. When the parties later determined that ASA's income allocations, and AlliedSignal's direct payments, to ABN had exceeded the specified return, AlliedSignal demanded and received a $315,000 refund. In sum, ABN was entitled to receive only its specified return--no more and no less.

The payment of the specified return violated the partnership agreement provision that "no interest" was to be paid on capital contributions. The precise amount of this return could not be determined until AlliedSignal and ABN knew ABN's actual interest rate on the funds it advanced and how long such funds were held in the partnership. Petitioner concedes that the direct payments to ABN depended on the amount of time ABN's funds were in ASA, yet it asks this

Court to conclude that the partnership provision barring interest on capital contributions was adhered to. We decline to do so. Cf. O'Hare v. Commissioner, 641 F.2d 83, 86 (2d Cir. 1981), (stating "It is hardly likely that a true owner or joint venturer would agree to an arrangement whereby his profit depended upon the timing of the sale rather than the amount of the proceeds of the sale. Such a payment mechanism clearly suggests a fee for the use of credit * * *"), affg. T.C. Memo. 1980-34. The direct payments, and the income allocations, to ABN were interest. Cf. Deputy v. duPont, 308 U.S. 488, 498 (1940) (defining "interest" as compensation for the use or forbearance of money).

Citing Hunt v. Commissioner, T.C. Memo. 1990-248, petitioner contends that even if ABN was entitled to a guaranteed return, such return "is not inconsistent with partnership treatment". Hunt, however, is distinguishable. First, in Hunt, the partnership agreement provided for the guaranteed return. ABN's specified return, however, was not provided in, and was contrary to, AlliedSignal's and ABN's partnership agreement. Second, in Hunt, the partner receiving the guaranteed return was also eligible to receive partnership profits in excess of such partner's guaranteed return. ABN, however, was only entitled to its specified return and nothing more. Cf. O'Hare v. Commissioner, supra at 87 (stating that the taxpayer's failure to share in any of the profits above his prearranged fee militated against a finding that he was a joint venturer). Therefore, Hunt v. Commissioner, supra, is inapplicable.

B. Loss Allocations

The partnership agreement provided that losses would be shared on a pro rata basis. ABN, however, did not intend to, nor did it actually, share in ASA's losses.

1. Loss on PPN Sale

Prior to meeting AlliedSignal's representative, Mr. den Baas told other ABN officials that ABN would not bear any loss relating to the PPN sale. The Bermuda Agreement was consistent with this representation. ABN's April 11, 1990, internal memorandum further confirms this agreement. It states: "Any possible loss (for whatever reason) on the sale of the medium term notes will be fully borne by Allied Signal." The parties ensured that AlliedSignal would bear such loss by embedding the cost of the PPN sale in the value of the LIBOR notes (i.e., the distribution of the LIBOR notes would result in a corresponding decrease in AlliedSignal's capital account).

2. Loss on LIBOR Notes

With respect to the LIBOR notes, the only ASA investment with any significant potential to fluctuate in value, ABN intended from the outset, and did, fully hedge its risk. A decline in interest rates, between the LIBOR notes acquisition date and AlliedSignal's August 2 purchase, resulted in a $6,342,068 decline in the LIBOR notes' value. Consequently, AlliedSignal paid $3,134,884 less to acquire Barber's and Dominguito's partnership interests than it would have paid if interest rates had remained constant. This "loss", however, was offset by ABN's swap income. As Mr. den Baas testified, "as soon as the hedge was in place, we didn't care anymore about the principal risk of the LIBOR notes". Moreover, when asked by the Court about ABN's upside potential relating to the LIBOR notes, Mr. den Baas explained that "we certainly took care that it would never happen", because any increase in the value of the LIBOR notes would be offset by losses from ABN's swap transactions.

Petitioner contends that in determining whether ABN bore any risk of loss relating to the LIBOR notes, the Court should not consider swap transactions outside the partnership. This contention, however, is inconsistent with petitioner's assertion that AlliedSignal's swaps were part of an "integrated investment strategy, which must be analyzed as a whole". Moreover, Merrill Lynch pitched and AlliedSignal purchased this package deal as an "integrated investment strategy" consisting of investments and swaps. ABN's swaps were part of this deal. AlliedSignal was fully aware that ABN, with assistance from the venture's facilitator (i.e., Merrill Lynch) would hedge its risk in the LIBOR notes. All testimony to the contrary was not credible. Accordingly, it is appropriate to consider both AlliedSignal's and ABN's swap transactions.

3. Loss Arising From Debt Issuers' Bankruptcy

Petitioner contends, and the partnership agreement provides, that ABN bore the risk of "any ASA loss attributable to the bankruptcy" of the commercial paper, PPN, and LIBOR note issuers. The commercial paper, which constituted most of ASA's portfolio, was AAA-rated, short-term, and from multiple issuers. The PPNs were issued by multiple AA-rated banks and held less than 30 days. The LIBOR notes were issued by multiple AAA-rated banks and held only 3 months. Indeed, Mr. den Baas testified that ASA held a "gorgeous portfolio" of assets and was "like a mini-bank" because it had "its own portfolio" of multiple "stellar" credit risks. In sum, ABN's "risk" relating to these assets was de minimis.

C. Expenses

The partnership agreement implied that expenses would be borne by the partners in accordance with their respective interests. Pursuant to the Bermuda Agreement, however, AlliedSignal was obligated to, and did in fact, pay all of ASA's expenses. We also note that AlliedSignal's obligation to bear expenses reduced AlliedSignal's return and undermined the stated purpose of "obtaining a yield in excess of what they could obtain from U.S. treasury securities".

D. Management

The partnership agreement stated that the partners would share in the management of ASA. The agreement provided that ASA's activities would require the "vote or consent" of partners whose partnership percentages totaled at least 95 percent. In reality, however, AlliedSignal made all the critical decisions. ABN was a compliant and accommodating party, which was chosen for the venture because it was willing to serve at AlliedSignal's direction.

The management provision in the partnership agreement was perfunctory, because the scheduled steps were prearranged by Merrill Lynch and agreed to by AlliedSignal and ABN before they executed the partnership agreement. The distribution of the LIBOR notes typifies how management responsibilities were "shared". Before the parties executed the partnership agreement, AlliedSignal had already decided that the LIBOR notes would be distributed to it. While the minutes of the August 21, 1990, meeting state that Dominguito's representative preferred cash distributions and expressed concern about the "volatility of the LIBOR notes", ABN had no such concern because it was fully hedged. The minutes were manufactured to give the impression that ABN was playing an active management role when it was not. From the outset of their relationship, ABN was fully aware that the LIBOR notes would be distributed to AlliedSignal.

E. Conclusion

The characteristics of AlliedSignal and ABN's relationship are contrary to the characteristics of a bona fide partnership. AlliedSignal and ABN had divergent, rather than common, interests. Moreover, they did not share in the venture's profit and losses and did not comply with their partnership agreement when it conflicted with the Bermuda Agreement. AlliedSignal and ABN knew that their conduct could jeopardize ASA's partnership status, so they carefully avoided documenting their true intent. In short, AlliedSignal, ASIC, and ABN's agents--Barber and Dominguito--did not have the requisite intent to join together for the purpose of carrying on a partnership and sharing in the profits and losses therefrom. Further analysis reveals that AlliedSignal and ABN had a debtor-creditor relationship.

V. Debtor-Creditor Relationship

Whether parties are in a partnership or a debtor-creditor relationship is a question of fact to be determined from all the facts and circumstances. Hambuechen v. Commissioner, 43 T.C. 90, 99 (1964); see Dixie Dairies Corp. v. Commissioner, 74 T.C. 476 (1980). "The ultimate question [is] whether the investment, analyzed in terms of its economic reality, constitutes risk capital entirely subject to the fortunes of the corporate venture" or represents a loan for which repayment was expected regardless of the success of the venture. Dixie Dairies Corp. v. Commissioner, supra at 494. The conduct of AlliedSignal and ABN confirms that they had a debtor-creditor relationship.

A. AlliedSignal

AlliedSignal did not recruit the foreign partner. Instead, it accepted Merrill Lynch's package deal that included a preselected partner. It is both typical and rational for bona fide partners to meet and negotiate prior to engaging in a $1 billion transaction involving numerous steps, complex swap arrangements, and investments in sophisticated financial instruments. Yet, AlliedSignal's Executive Committee approved the plan before it even knew the identity of the foreign partner. The Board approved the plan 2 weeks after the venture began. AlliedSignal, like a typical borrower, was only concerned that a strong, reputable bank was financing the transaction. The identity of the bank was irrelevant.

AlliedSignal spent a considerable amount of time ensuring that ABN received its specified return and was preoccupied with determining the amount of, and the labels attached to, the direct payments to ABN. Petitioner contends that there was no assurance, commitment, or binding agreement to pay ABN a specified return. AlliedSignal, however, scrupulously calculated the shortfall between Barber's and Dominguito's income allocations and ABN's specified return and recorded this shortfall as an accrued liability for financial purposes. AlliedSignal wanted to ensure that its direct payments, and ASA's income allocations, to ABN were being properly credited toward AlliedSignal's obligation to pay ABN's specified return. In essence, AlliedSignal's conduct resembled that of a meticulous borrower rather than a partner.

B. ABN

From the outset of the venture, ABN processed the ASA transaction just like any other large corporate loan. For loans more than $25 million, ABN required approval from its North American Credit Committee, Foreign Credit Department, and headquarters. Accordingly, ABN New York submitted the loan application relating to the plan, and ABN approved the loan, through the aforementioned channels. Although ABN was, ostensibly, considering a loan to Barber and Dominguito, it evaluated and approved the loan based on AlliedSignal's financial statements. In addition, the ABN loan-approval committees authorized the loan only after they were assured that the loan contained terms and degrees of risk commensurate with loans that it ordinarily makes.

ABN, like most prudent lenders, attempted to insulate itself from credit risk by establishing certain safeguards. It insisted that most of ASA's investments be in high-grade, low-risk, short-term notes. In addition, by lending the funds through Barber and Dominguito, rather than directly to AlliedSignal, ABN established a direct interest in, what Mr. den Baas characterized as, a "gorgeous portfolio" of AAA-rated, diversified, high-grade assets, rather than a $990 million loan to a signal A-rated company. Furthermore, ABN had collateral for the funds it transferred to ASA, because ASA's commercial paper was physically kept in ABN's vault and ASA's other investments were maintained in a custody account at ABN New York.

ABN merely sought its specified return. This return was equivalent to interest and was guaranteed by AlliedSignal. The parties agreed that ABN would be repaid according to a specified schedule, which established fixed maturity dates when ABN was to be repaid (i.e., August 1990, March 1991, and full repayment by May 1992). If AlliedSignal missed a payment date, it compensated ABN for the prolonged period (e.g., the December 5, 1991, payment of $231,250 of interest because ASA partially redeemed ABN's interest in November, rather than March, of 1991). In addition, by engaging in swap transactions, ABN restricted its ability to earn "a rate of return in excess of the rate available on direct investments in the securities which the Partnership plans to purchase". Mr. den Baas testified that ABN did not want to gamble on interest rates and that its swaps were designed to prevent ABN from sharing in profits or losses from the LIBOR notes--the ASA asset with the most profit potential.

We must look to the substance of the transactions rather than the form. Hambuechen v. Commissioner, supra at 98; see Gregory v. Helvering, 293 U.S. 465 (1935). When the formalities are stripped away, ABN is in substance a lender. Accordingly, we hold that Barber and Dominguito were not partners in ASA and that the appropriate amount of gain relating to the sale of the PPNs and loss relating to the sale of the LIBOR notes shall be allocated between AlliedSignal and ASIC.

All contentions that have not been addressed are either irrelevant, moot, or meritless.

To reflect the foregoing,

Decision will be entered

under Rule 155.

UNITED STATES TAX COURT

ASA INVESTERINGS PARTNERSHIP ALLIEDSIGNAL INC., TAX MATTERS PARTNER, Petitioner,	)
v.	) Docket No. 27320-96
COMMISSIONER OF INTERNAL REVENUE, Respondent.	) Judge Foley

DECISION

Pursuant to the determination of the Court in its opinion filed August 20, 1998, it is

ORDERED AND DECIDED:

That pursuant to I.R.C. § 6233 the following statement shows the adjustments to the partnership items reported by ASA Investerings Partnership ("ASA") on returns filed for its reported taxable years ending May 31, 1990, May 31, 1991, December 31, 1991, and June 1, 1992:

Reported Taxable Year Ending May 31, 1990

Partnership Item	As Reported	As Determined
Net Short-Term Taxable Gain	$539,443,361	$539,365,656
Interest Income	$ 7,642,097	$ 7,642,097
Interest Expense	$ -0-	$ 6,834,083
Other Expense	$ 4	$ 4

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Reported Taxable Year Ending May 31, 1991

Partnership Item	As Reported	As Determined
Interest Income	$ 64,990,874	$ 64,990,874
Interest Expense	$ -0-	$ 37,298,482
Amortization Expense	$ 31,845	$ 31,845
Other Expense	$ 197,238	$ 197,238
Basis of LIBOR Notes As of August 21, 1990	$709,283,197	$709,671,723

Reported Taxable Year Ending December 31, 1991

Partnership Item	As Reported	As Determined
Interest Income	$ 27,181,723	$ 27,181,723
Interest Expense	$ -0-	$ 12,013,170
Amortization Expense	$ 20,271	$ 20,271
Other Expense	$ 62,839	$ 62,839

Reported Taxable Year Ending June 1, 1992

Partnership Item	As Reported	As Determined
Interest Income	$13,679,299	$ 13,679,299
Interest Expense	$ -0-	$ 4,012,258
Amortization Expense	$ 121,638	$ 121,638
Other Expense	$ 7,616	$ 7,616

That Allied's payment of $4.4 million on August 2, 1990 is included in the $37,298,482 of interest expense determined for the reported taxable year ending May 31, 1991, and is not includible in the basis of the LIBOR Notes sold by Allied and ASIC.

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That Allied's payment of $1,631,250 on December 5, 1991 (less $315,000 returned by ABN) is included in the $12,013,170 of interest expense determined for the reported taxable year ending December 31, 1991, and is not includible in the basis of the LIBOR Notes sold by Allied and ASIC.

That pursuant to I.R.C. § 6233 the following statement shows the adjustments to the allocation of the partnership items:

Allied
Taxable Year Ending December 31, 1990

Partnership Item	As Claimed	As Determined
Net Short Term Capital Gain	$ 48,531,902	$533,971,999
Interest Income	$ 659,742	$ 48,643,868
Interest Expense	$ -0-	$ 34,315,760
Amortization Expense	$ 1	$ 14,335
Other Expense	$ -0-	$ 150,596
Basis of LIBOR Notes As of August 21, 1990	$697,348,518	$697,730,419

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Allied
Taxable Year Ending December 31, 1991

Partnership Item	As Claimed	As Determined
Interest Income	$ 47,538,104	$ 50,172,679
Interest Expense	$ -0-	$ 21,640,681
Amortization Expense	$ 29,284	$ 34,402
Other Expense	$ 135,380	$ 106,881

Allied
Taxable Year Ending December 31, 1992

Partnership Item	As Claimed	As Determined
Interest Income	$ 9,388,346	$ 13,542,506
Interest Expense	$ -0-	$ 3,660,285
Amortization Expense	$ 83,576	$ 123,279
Other Expense	$ 5,333	$ 7,540

ASIC
Taxable Year Ending December 31, 1990

Partnership Item	As Claimed	As Determined
Net Short Term Capital Gain	$ 5,394,434	$ 5,393,657
Interest Income	$ 73,205	$ 491,352
Interest Expense	$ -0-	$ 302,179
Amortization Expense	$ -0-	$ 145
Other Expense	$ -0-	$ 1,521
Basis of LIBOR Notes As of August 21, 1990	$ 11,934,677	$ 11,941,304

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ASIC
Taxable Year Ending December 31, 1991

Partnership Item	As Claimed	As Determined
Interest Income	$ 926,864	$ 506,795
Interest Expense	$ -0-	$ 202,115
Amortization Expense	$ 525	$ 348
Other Expense	$ 2,605	$ 1,080

ASIC
Taxable Year Ending May 28, 1992

Partnership Item	As Claimed	As Determined
Interest Income	$ 154,483	$ 136,793
Interest Expense	$ -0-	$ 36,973
Amortization Expense	$ -0-	$ 1,245
Other Expense	$ -0-	$ 76

Barber
Taxable Year Ending May 31, 1990

Partnership Item	As Claimed	As Determined
Net Short Term Capital Gain	$194,199,610	$ -0-
Interest Income	$ 2,763,660	$ -0-
Interest Expense	$ -0-	$ -0-
Amortization Expense	$ 1	$ -0-
Other Expense	$ -0-	$ -0-
Basis of LIBOR Notes As of August 21, 1990	$ -0-	$ -0-

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Barber
Taxable Year Ending May 31, 1991

Partnership Item	As Claimed	As Determined
Interest Income	$ 4,809,118	$ -0-
Interest Expense	$ -0-	$ -0-
Amortization Expense	$ 1,043	$ -0-
Other Expense	$ 12,227	$ -0-

Dominguito
Taxable Year Ending May 31, 1990

Partnership Item	As Claimed	As Determined
Net Short Term Capital Gain	$291,299,415	$ -0-
Interest Income	$ 4,145,490	$ -0-
Interest Expense	$ -0-	$ -0-
Amortization Expense	$ 2	$ -0-
Other Expense	$ -0-	$ -0-
Basis of LIBOR Notes As of August 21, 1990	$ -0-	$ -0-

Dominguito
Taxable Year Ending May 31, 1991

Partnership Item	As Claimed	As Determined
Interest Income	$ 28,176,355	$ -0-
Interest Expense	$ -0-	$ -0-
Amortization Expense	$ 13,317	$ -0-
Other Expense	$ 84,630	$ -0-

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Dominguito
Taxable Year Ending May 31, 1992

Partnership Item	As Claimed	As Determined
Interest Income	$14,858,626	$ -0-
Interest Expense	$ -0-	$ -0-
Amortization Expense	$ 44,629	$ -0-
Other Expense	$ 27,433	$ -0-

Entered: Dec. 3, 1998 (Signed) Maurice B. Foley

Judge.

Docket No. 27320-96

The parties stipulate that the foregoing decision is in accordance with the opinion of the Court and the respondent's computation, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein.

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Date: November 19, 1998	Date: 12-1-98

United States Court of Appeals
For the District of Columbia Circuit

No. 98-1583 **September Term, 1999**

ASA Investerings Partnership, et al., **Filed On: April 24, 2000**
Appellants

v.

Commissioner of Internal Revenue Service,
Appellee

BEFORE: Williams, Sentelle and Henderson, Circuit Judges

ORDER

Upon consideration of petitioner's petition for rehearing filed March 15, 2000, it is

ORDERED that the petition be denied.

Per Curiam

FOR THE COURT:
Mark J. Langer, Clerk

BY:
Robert A. Bonner
Deputy Clerk

United States Court of Appeals
For the District of Columbia Circuit

No. 98-1583 **September Term, 1999**

ASA Investerings Partnership, et al., **Filed On: April 24, 2000**
Appellants

v.

Commissioner of Internal Revenue Service,
Appellee

BEFORE: Edwards, Chief Judge; Silberman, Williams, Ginsburg, Sentelle, Henderson, Randolph, Rogers, Tatel and Garland, Circuit Judges

ORDER

Upon consideration of petitioner's petition for rehearing en banc, the response thereto, and the absence of a request by any member of the court for a vote, it is

ORDERED that the petition be denied.

Per Curiam

FOR THE COURT:
Mark J. Langer, Clerk

BY:
Robert A. Bonner
Deputy Clerk

Circuit Judge Garland did not participate in this matter.

I.R.C. § 453

(In Pertinent Part)

Installment method

(a) **Use of installment method.--**

(1) **In general.**--Except as otherwise provided in this section, income from an installment sale shall be taken into account for purposes of this title under the installment method.

* * *

(b) **Installment sale defined.**--For purposes of this section--

(1) **In general.**--The term "installment sale" means a disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs.

* * *

(c) **Installment method defined.**--For purposes of this section, the term "installment method" means a method under which the income recognized for any taxable year from a disposition is that proportion of the payments received in that year which the gross profit (realized or to be realized when payment is completed) bears to the total contract price.

* * *

(j) **Regulations.--**

(1) **In general.**--The Secretary shall prescribe such regulations as may be necessary

or appropriate to carry out the provisions of this section.

(2) Selling price not readily ascertainable.--The regulations prescribed under paragraph (1) shall include regulations providing for ratable basis recovery in transactions where the gross profit or the total contract price (or both) cannot be readily ascertained.

* * *

I.R.C. § 704

(In Pertinent Part)

Partner's distributive share.

* * *

(e) Family partnerships.–

(1) Recognition of interest created by purchase or gift.--A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.

* * *

I.R.C. § 761

(In Pertinent Part)

Terms defined.

(a) Partnership.--For purposes of this subtitle, the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate. Under regulations the Secretary may, at the election of all the members of an unincorporated organization, exclude such organization from the application of all or part of this subchapter, if it is availed of--

(1) for investment purposes only and not for the active conduct of a business,

(2) for the joint production, extraction, or use of property but not for the purpose of selling services or property produced or extracted, or

(3) by dealers in securities for a short period for the purpose of underwriting, selling, or distributing a particular issue of securities,

if the income of the members of the organization may be adequately determined without the computation of partnership taxable income.

(b) Partner.--For purposes of this subtitle, the term "partner" means a member of a partnership.

(c) Partnership agreement.--For purposes of this subchapter, a partnership agreement includes any modifications of the partnership agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners, or which are adopted in such other manner as may be provided by the partnership agreement.

* * *

I.R.C. § 7482

(In Pertinent Part)

Courts of review.

(a) Jurisdiction.--

(1) In general.--The United States Courts of Appeals (other than the United States Court of Appeals for the Federal Circuit) shall have exclusive jurisdiction to review the decisions of the Tax Court, except as provided in section 1254 of Title 28 of the United States Code, in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury; and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari, in the manner provided in section 1254 of Title 28 of the United States Code.

* * *

(b) Venue.--

(1) In general.--Except as otherwise provided in paragraphs (2) and (3), such decisions may be reviewed by the United States court of appeals for the circuit in which is located--

* * *

(E) in the case of a petition under section 6226, 6228(a), 6247, or 6252, the principal place of business of the partnership, or

* * *

If for any reason no subparagraph of the preceding sentence applies, then such decisions may be reviewed by the Court of Appeals for the District of Columbia. For purposes of this paragraph, the legal residence, principal place of business, or principal office or agency referred to herein shall be determined as of the time the petition seeking redetermination of tax liability was filed with the Tax Court or as of the time the petition seeking a declaratory decision under section 7428 or 7476, or the petition under section 6226, 6228(a), or 6234(c) was filed with the Tax Court.

* * *

I.R.C. § 7701

(In Pertinent Part)

Definitions.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof--

* * *

> (2) **Partnership and partner.**--The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

* * *

Temp. Treas. Reg. § 15A.453-1

Installment method reporting for sales of real property and casual sales of personal property (Temporary).

* * *

(c) **Contingent payment sales --**

(1) **In general --**

* * *

(3) **Fixed period --**

(i) **In general.** When a stated maximum selling price cannot be determined as of the close of the taxable year in which the sale or other disposition occurs, but the maximum period over which payments may be received under the contingent sale price agreement is fixed, the taxpayer's basis (inclusive of selling expenses) shall be allocated to the taxable years in which payment may be received under the agreement in equal annual installments. In making the allocation it is not relevant whether the buyer is required to pay adequate stated interest. However, if the terms of the agreement incorporate an arithmetic component that is not identical for all taxable years, basis shall be allocated among the taxable years to accord with that component unless, taking into account all of the payment terms of the agreement, it is inappropriate to presume that payments under the contract are likely to accord with the variable component. If in any taxable year no payment is received or the amount of payment received (exclusive of interest) is less than the basis allocated to that taxable year, no loss shall be allowed unless the taxable year is the final payment year under the agreement or unless it is otherwise determined in accordance with the rules generally applicable to worthless debts that the future payment obligation under the agreement has become worthless. When no loss is allowed, the unrecovered portion of the basis allocated to the taxable year shall be carried forward to the next succeeding taxable year. If application of the foregoing rules to a particular case would substantially and inappropriately defer or accelerate recovery of the taxpayer's basis, a special rule will apply. See paragraph (c)(7) of this section.

* * *

(7) Special rule to avoid substantial distortion–

(i) In general. The normal basis recovery rules set forth in paragraph (c)(2) through (4) of this section may, with respect to a particular contingent payment sale, substantially and inappropriately defer or accelerate recovery of the taxpayer's basis.

(ii) Substantial and inappropriate deferral. The taxpayer may use an alternative method of basis recovery if the taxpayer is able to demonstrate prior to the due date of the return including extensions for the taxable year in which the first payment is received, that application of the normal basis recovery rule will substantially and inappropriately defer recovery of basis. To demonstrate that application of the normal basis recovery rule will substantially and inappropriately defer recovery of basis, the taxpayer must show (A) that the alternative method is a reasonable method of ratably recovering basis and, (B) that, under that method, it is reasonable to conclude that over time the taxpayer likely will recover basis at a rate twice as fast as the rate at which basis would have been recovered under the otherwise applicable normal basis recovery rule. The taxpayer must receive a ruling from the Internal Revenue Service before using an alternative method of basis recovery described in paragraph (c)(7)(ii) of this section.

The request for a ruling shall be made in accordance with all applicable procedural rules set forth in the Statement of Procedural Rules (26 CFR Part 601) and any applicable revenue procedures relating to submission of ruling requests. The request shall be submitted to the Commissioner of Internal Revenue, Attention: Assistant Commissioner (Technical), Washington, DC 20224. The taxpayer must file a request for a ruling prior to the due date for the return including extensions. In demonstrating that application of the normal basis recovery rule would substantially and inappropriately defer recovery of the taxpayer's basis, the taxpayer in appropriate circumstances may rely upon contemporaneous or immediate past relevant sales, profit, or other factual data that are subject to verification. The taxpayer ordinarily is not permitted to rely upon projections of future productivity, receipts, profits, or the like. However, in special circumstances a reasonable projection may be acceptable if the projection is based upon a specific event that already has occurred (e.g., corporate stock has been sold for future payments contingent on profits and an inadequately insured major plant facility of the corporation has been destroyed).

(iii) Substantial and inappropriate acceleration. Notwithstanding the other provisions of this paragraph, the Internal Revenue Service may find that the normal basis recovery rule will substantially and inappropriately accelerate recovery of basis. In such a case, the Service may require an alternate method of basis recovery, unless the taxpayer is able to demonstrate either (A) that the method of basis recovery required by the Service is not a reasonable method of ratable recovery, or (B) that it is not reasonable to conclude that the taxpayer over time is likely to recover basis at a rate twice as fast under the normally applicable basis recovery rule as the rate at which basis would be recovered under the method proposed by the Service. In making such demonstrations the taxpayer may rely in appropriate circumstances upon contemporaneous or immediate past relevant sales, profit, or other factual data subject to verification. In special circumstances a reasonable projection may be acceptable, but only with the consent of the Service, if the projection is based upon a specific event that has already occurred.

(iv) Subsequent recomputation. A contingent payment sale may initially and properly have been reported under the normally applicable basis recovery rule and, during the term of the agreement, circumstances may show that continued reporting on the original method will substantially and inappropriately defer or accelerate recovery of the unrecovered balance of the taxpayer's basis. In this event, the special rule provided in this paragraph is applicable.

Treas. Reg. § 1.704-1

(In Pertinent Part)

Partner's distributive share. –

* * *

(e) Family partnerships --

(1) In General

* * *

(v) Capital interest in a partnership. For purposes of section 704(e), a capital interest in a partnership means an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership. The mere right to participate in the earnings and profits of a partnership is not a capital interest in the partnership.

* * *

Treas. Reg. § 1.761-1

(In Pertinent Part)

Terms defined.

(a) Partnership. The term partnership means a partnership as determined under §§ 301.7701-1, 301.7701-2, and 301.7701-3 of this chapter.

(b) Partner. The term partner means a member of a partnership.

(c) Partnership agreement. For the purposes of subchapter K, a partnership agreement includes the original agreement and any modifications thereof agreed to by all the partners or adopted in any other manner provided by the partnership agreement. Such agreement or modifications can be oral or written. A partnership agreement may be modified with respect to a particular taxable year subsequent to the close of such taxable year, but not later than the date (not including any extension of time) prescribed by law for the filing of the partnership return. As to any matter on which the partnership agreement, or any modification thereof, is silent, the provisions of local law shall be considered to constitute a part of the agreement.

* * *

(2)

Supreme Court, U.S.
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No. 00-008

In the Supreme Court of the United States

ASA INVESTERINGS PARTNERSHIP, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

*ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT*

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether petitioner was a valid partnership for federal tax purposes.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-23a) is reported at 201 F.3d 505. The opinion of the Tax Court (Pet. App. 24a-58a) is reported at 76 T.C.M. (CCH) 325.

JURISDICTION

The judgment of the court of appeals was entered on February 1, 2000. The petition for rehearing and petition for rehearing en banc was denied on April 24, 2000. Pet. App. 67a, 68a. The petition for a writ of certiorari was filed on June 30, 2000. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. In 1990, AlliedSignal decided to sell its interest in Union Texas Petroleum Holdings, Inc. Pet. App. 2a. In an effort to eliminate the tax liability flowing from the anticipated $400 million of capital gains arising from that sale, AlliedSignal contacted the Merrill Lynch Company concerning a tax shelter scheme that company was then promoting. *Id.* at 6a.

Merrill Lynch had developed a tax avoidance scheme that was designed to generate large paper losses for a corporation to use to shelter from tax an equal amount of capital gains realized by the corporation. Pet. App. 6a. The plan involved (i) creating a purported "partnership" that would have a foreign entity not subject to United States taxation as one of its partners and (ii) having that entity enter into a contingent installment sale to invoke the ratable basis recovery rule in Temporary Income Tax Regulations Under the Installment Sales Revision Act (Temp. Treas. Reg.) § 15A.453-1(c)(3)(i) (1981). The ratable basis recovery rule is a rule of tax accounting that applies to "contingent installment sales" of property reportable under the installment method of accounting provided by Section 453 of the Internal Revenue Code. A contingent installment sale is a transaction that extends over a period of more than one year and that has an indeterminate sales price on the date of sale. The ratable basis recovery rule allows the seller in a contingent installment sale to recover its basis in the asset over the period of the transaction. [1]

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[1] Merrill Lynch marketed the scheme to eight large United States corporations, including AlliedSignal, the real party in interest in this case, and Colgate-Palmolive Company, the real party in interest in *ACM Partnership* v. *Commissioner*, 157 F.3d 231, 233-

The tax shelter scheme being promoted by Merrill Lynch involved the following steps (Pet. App. 26a-27a):

> (1) AlliedSignal was to enter into a partnership with a foreign entity that was not subject to United States taxation.
>
> (2) Upon the formation of the partnership, the foreign entity was to have the overwhelming majority partnership interest while AlliedSignal would own a distinct minority interest.
>
> (3) To come under the ratable basis recovery regulation, the partnership was to purchase short-term private placement securities that were eligible for the installment method of accounting provided under Section 453 of the Code and was then promptly to sell those instruments for a large amount of cash and a comparatively small amount of debt instruments whose yield over a fixed period of time was not ascertainable. The gain from the sale of the private placement securities was to be allocated among the partners for federal tax purposes in accordance with their percentage partnership interests.
>
> (4) Under Temp. Treas. Reg. § 15A.453-1(c)(3)(i), the partnership would claim a large "basis" in the debt instruments acquired in exchange for the private placement securities.

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234 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999). In *ACM*, the court of appeals determined that, by creating paper gains and paper losses, the Merrill Lynch transaction lacked economic substance. The court therefore held that neither the paper gains nor the paper losses reported on the partnership returns were to be recognized for federal tax purposes. 157 F.3d at 263.

(5) AlliedSignal would then acquire a majority interest in the partnership during its following taxable year by purchasing a portion of the interest owned by the foreign entity.

(6) The partnership would thereafter distribute the debt instruments with the large basis to AlliedSignal and distribute cash to the foreign entity in a partial redemption of their partnership interests.

(7) AlliedSignal would then sell the debt intruments to a third party. Because the basis of the instruments would then greatly exceed their value, this disposition would result in a large paper loss. AlliedSignal would then use the paper "loss" from the transaction to shelter from tax the capital gain it had realized from the sale of its interest in UTP. The partnership would then terminate.

The foreign partner in the proposed partnership was to be a Netherlands financial institution named Algemene Bank Netherland N.V. (ABN). Pet. App. 7a. ABN entered into the arrangement as an accommodation to AlliedSignal, which was a customer of its banking services. *Ibid.*[2] AlliedSignal paid all of the costs incurred by ABN in this transaction and also paid ABN a fee of $5 million for its participation. *Id.* at 8a.

The Merrill Lynch scheme was implemented in the spring of 1990. AlliedSignal and a newly-created, wholly-owned subsidiary entered into a "partnership" with two Netherlands Antilles "special purpose corporations." Pet. App. 9a. The special purpose corporations were controlled by foundations that were, in turn, controlled by ABN. *Ibid.* The AlliedSignal subsidiary was known as AlliedSignal Investment Corporation (ASIC); the Netherlands Antilles corporations were known as Dominguito Corporation N.V. (Dominguito) and Barber Corporation N.V. (Barber). *Ibid.* The partnership that they formed is petitioner ASA Investerings Partnership.

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[2] ABN also served as the foreign partner in other similar arrangements marketed by Merrill Lynch to large United States corporations. Pet. App. 7a.

AlliedSignal contributed $99 million in exchange for a 9% partnership interest. Pet. App. 34a. ASIC contributed $11 million in exchange for a 1% partnership interest. *Ibid.* Dominguito contributed $594 million in exchange for a 54% partnership interest. *Ibid.* Barber contributed $396 million in exchange for a 36% partnership interest. *Ibid.*

On April 25, 1990, petitioner purchased $350 million of five-year floating rate notes issued by the Long Term Credit Bank of Japan and $500 million of five-year floating rate notes issued by Sumitomo Bank Capital Markets, Inc. Pet. App. 9a-10a. Between May 17, 1990, and May 24, 1990, ASA sold the private placement notes to two banks for $681,300,000 in cash and 11 London Interbank Offering Rate (LIBOR) Notes. *Id.* at 10a. The LIBOR is the primary fixed income rate used in Euro markets. *Id.* at 26a n.1. LIBOR Notes are instruments that pay variable amounts at three-month periods (reflecting adjustments in the LIBOR during the period) on a fixed sum ("a notional principal amount").[3] The LIBOR Notes purchased by petitioner provided for quarterly payments for 20 quarters commencing August 31, 1990, on a notional amount of $434,749,000. *Id.* at 37a.

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[3] The owner of a LIBOR Note effectively purchases a stream of payments for a certain period that includes a recovery of principal as well as an interest component. The purchaser of a LIBOR Note

2. On its partnership tax return for the 1990 taxable year (ending on May 31, 1990), petitioner treated the sale of the private placement notes as an "installment sale" under Section 453(b) of the Internal Revenue Code and as a "contingent payment sale" under Temp. Treas. Reg. § 15A.453-1(c). Pet. App. 38a-39a. Petitioner therefore reported a gain of $539,443,361 from these transactions for 1990, which reflected the excess of the cash received from the sale of the private placement notes ($681,300,000) over the portion of the basis in the LIBOR Notes recovered during that year (computed by ASA to be $141,856,639). *Id.* at 10a-11a.[4] The gain was allocated to the partners based upon their ownership interests: $48,531,902 was allocated to AlliedSignal; $5,394,434 was allocated to ASIC; $291,299,415 was allocated to Dominguito; and $194,199,610 was allocated to Barber. *Id.* at 39a. Barber and Dominguito did not pay any United States or other tax on the gain allocated to them from the sale of the private placement notes.

On August 21, 1990, petitioner distributed the LIBOR Notes acquired in May 1990 to AlliedSignal and ASIC in partial redemption of their interests in petitioner, and distributed cash and commercial paper to Dominguito in partial redemption of its interest in

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makes a profit if the rate rises, and incurs a loss if the rate declines.

[4] The parties stipulated in the Tax Court that petitioner had erred in computing the gain reported on its 1990 return, and that the correct amount of the reported gain was $539,364,656. Pet. App. 11a n.3.

petitioner. Pet. App. 41a. The LIBOR Notes distributed to AlliedSignal were valued at $167,469,860; the notes distributed to ASIC were valued at $2,866,140; the cash and commercial paper distributed to Dominguito totaled $116,279,033. *Ibid.* AlliedSignal determined that its adjusted basis in the LIBOR Notes distributed to it was $697,348,518, and that ASIC's adjusted basis in the Notes distributed to it was $11,934,677. *Id.* at 42a.

On September 6, 1990, AlliedSignal sold some of its LIBOR Notes to Unibank A/S for $17,502,543 in cash. AlliedSignal reported a capital loss of $65,097,013 on that sale. Pet. App. 42a. In November 1990, AlliedSignal sold other LIBOR Notes in two separate transactions. AlliedSignal sold some of those Notes to Generale Bank for $17,129,250 in cash, and reported a capital loss of $65,714,370 on the sale. *Ibid.* AlliedSignal sold other LIBOR Notes to Unibank for $15,822,310 in cash, and reported a capital loss of $65,255,321 on the sale. *Ibid.* For its 1990 taxable year (ending December 31, 1990), AlliedSignal thus reported a total of $196,066,704 in capital losses from the sale of the LIBOR Notes. *Ibid.* Setting those losses off against the capital gain reported by AlliedSignal and ASIC from petitioner's sale of the private placement notes ($53,926,336), AlliedSignal reported a 1990 tax loss of $142,140,367 from the Merrill Lynch transaction. AlliedSignal then carried this loss back to its 1987 taxable year and claimed a refund of taxes paid during that year. *Ibid.*

On November 22, 1991, petitioner distributed $91,898,434 to Dominguito in redemption of 7.57% of Dominguito's remaining interest in petitioner. Pet. App. 43a. On December 5, 1991, AlliedSignal made a $1,631,250 payment to ABN. This amount consisted of

(i) a $765,147 payment that reflected the amount by which the income from petitioner to Barber and Dominguito fell below ABN's LIBOR-based funding costs, (ii) a $634,853 payment that constituted the remainder of ABN's $5 million fee for participating in the Merrill Lynch transaction (plus interest), and (iii) a $231,250 interest payment that reflected the fact that ABN had allowed $92 million to remain in the partnership coffers longer than the parties had anticipated. *Ibid.*[5]

On April 8, 1992, petitioner distributed $76,961,863 in cash to Dominguito in redemption of Dominguito's remaining interest in petitioner. Pet. App. 44a. On May 28, 1992, ASIC transferred its 1.26% interest in petitioner to AlliedSignal. Shortly thereafter, AlliedSignal liquidated the partnership. *Ibid.*

In the fall of 1992, AlliedSignal concluded the intended sale of its interest in Union Texas Petroleum Holdings, realizing a capital gain of $264,667,000 on that transaction. Pet. App. 45a-46a. AlliedSignal subsequently sold its remaining LIBOR Notes for $33,431,000. *Id.* at 46a. On its 1992 consolidated federal income tax return, AlliedSignal reported a capital loss of $396,234,738 from its sale of the LIBOR Notes and used this loss to offset the $264,667,000 in capital gain realized on the sale of its interest in Union Texas Petroleum Holdings. The 1992 losses remaining after application against the gains from the Union Texas sale were carried back to offset capital gains realized by AlliedSignal during 1989 and 1991 and carried forward to offset capital gains realized during 1993, 1994, and 1995. *Ibid.*

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[5] In addition to participating in the Merrill Lynch transaction, petitioner purchased certain interest-bearing instruments during its existence, most notably commercial paper issued by AlliedSignal. See Pet. App. 39a-40a.

The transaction costs and expenses incurred by AlliedSignal on these transactions—including the fees paid to Merrill Lynch and ABN—totaled almost $25 million. Pet. App. 22a. Although AlliedSignal claimed a tax loss exceeding $538 million from the transaction arranged by Merrill Lynch, it actually made an economic profit of approximately $3.6 million from its participation in the transaction. *Id.* at 22a-23a.

3. The Internal Revenue Service audited petitioner's partnership returns for 1990 through 1992 and determined that the ABN affiliates had not entered into a valid partnership with AlliedSignal (and ASIC). The Commissioner therefore adjusted petitioner's returns to allocate all the gains and losses reported by petitioner to AlliedSignal and ASIC.[6]

Petitioner filed a petition in Tax Court to contest the proposed adjustments.[7] The Tax Court, however, sustained the Commissioner's determinations and agreed with the Commissioner that petitioner was not a valid partnership for federal tax purposes. Pet. App.

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[6] The Commissioner also proposed alternative adjustments that reflected other theories. Neither the Tax Court nor the court of appeals addressed those theories.

[7] As a result of amendments to the Internal Revenue Code made by the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324, tax litigation involving, partnership items now is conducted in a single proceeding in the name of the partnership. Following the completion of such litigation, appropriate computational adjustments are made to the tax returns of each of the partners to reflect the results of the partnership level litigation. See 26 U.S.C. 6221-6233. The instant litigation thus was conducted in the name of petitioner ASA Investerings Partnership. AlliedSignal, however, is the real party in interest.

24a-58a. The court observed that the existence of a partnership for federal tax purposes depends on whether "the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." *Id.* at 47a-48a (quoting *Commissioner* v. *Culbertson*, 337 U.S. 733, 742 (1949)). In applying that test, the Tax Court disregarded Barber and Dominguito—because those entities were simply ABN's "agents"—and focused on the purported business purpose of AlliedSignal and ABN. Pet. App. 48a-49a. The court determined that AlliedSignal and ABN had not in fact joined together for the purpose of investing in interest-bearing instruments as petitioner contended (*id.* at 49a):

> AlliedSignal and ABN had divergent business goals. AlliedSignal entered into the venture for the sole purpose of generating capital losses to shelter an anticipated capital gain. In pursuing this goal, AlliedSignal chose to ignore transaction costs, profit potential, and other fundamental business considerations. In fact, AlliedSignal's Board and the Board's Executive Committee focused only on potential tax benefits when they approved the plan.
>
> In contrast, ABN entered into the venture for the sole purpose of receiving its specified return. This return was independent of the performance of ASA's investments (e.g., the profitability of the LIBOR notes) and the success of the venture (i.e., whether AlliedSignal succeeded in generating capital losses). Moreover, as will be explained, ABN did not have any profit potential beyond its specified return and did not have any intention of being AlliedSignal's partner. * * *

The Tax Court concluded that the partnership was a "facade," that the income allocations provided for by the partnership agreement "were merely an artifice to pay ABN's specified return," and that the loss allocations in the agreement were disingenuous because "ABN * * * did not intend to, nor did it actually, share in ASA's losses." Pet. App. 50a-51a. The court noted that, by separate agreement with ABN, AlliedSignal bore all of the expenses of ABN and its affiliates in these transactions. *Id.* at 53a. The Tax Court concluded that the relationship between AlliedSignal and ABN was merely a contractual, debtor-creditor relationship, not a partnership. *Id.* at 55a-58a.

4. The court of appeals affirmed. Pet. App. 1a-23a. The court ruled that the Tax Court decision was "sound in its basic inquiry, trying to decide whether, all facts considered, the parties intended to join together as partners to conduct business activity for a purpose other than tax avoidance." *Id.* at 18a. The court of appeals concluded that the factual record "amply supports" the Tax Court's finding "that none of the supposed partners had the intent to form a real partnership * * *." *Id.* at 23.

ARGUMENT

The fact-intensive determination of the courts below that petitioner was not a valid partnership for federal tax purposes properly applies the decisions of this Court and does not conflict with the decisions of any other court of appeals. Further review is therefore not warranted.

1. a. In *Commissioner* v. *Tower*, 327 U.S. 280, 286 (1946), and *Commissioner* v. *Culbertson*, 337 U.S. 733 (1949), this Court set forth standards for determining

whether parties have created a valid partnership for federal tax purposes. In *Tower*, the taxpayer had managed and controlled a corporation engaged in the manufacturing and sale of sawmill machinery and wood and metal stampings for ten years. 327 U.S. at 285. In an effort to reduce his taxes, the taxpayer dissolved the corporation and formed a purported partnership with his wife. *Ibid.* The purpose of that arrangement was to split the income from the business between the husband and wife and thereby reduce the net tax on that income.

This Court determined that a valid partnership had not been created for federal tax purposes and that the husband was therefore subject to tax on the entire income from the business. The Court stressed that the question whether a valid partnership had been formed for federal tax purposes is factual in nature and centers on whether the alleged partners "really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both." 327 U.S. at 287. The Court concluded on the record before it that "[t]here was * * * more than ample evidence to support the Tax Court's finding that no genuine union for partnership business purposes was ever intended and that the husband earned the income." *Id.* at 292. In the Court's view, a contrary conclusion "would [have] mean[t] ordering the Tax Court to shut its eyes to the realities of tax avoidance schemes." *Id.* at 289.

In *Culbertson*, the taxpayer had been a partner in a partnership engaged in the cattle business. When his partner expressed the desire to terminate the business, the taxpayer formed a purported partnership with his four sons to continue the business. This Court held that the critical question in determining whether the taxpayer and his sons had created a valid partnership was whether, "considering all the facts * * * the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." 337 U.S. at 742.

b. The Tax Court and the court of appeals correctly applied the standards set forth in *Tower* and *Culbertson* in concluding that petitioner was not a valid partnership for federal tax purposes. The nature of the relationship between AlliedSignal and its putative partners belies the existence of a legitimate partnership. AlliedSignal formed petitioner for the sole purpose of creating artificial tax losses for itself. Pet. App. 6a, 22a. Its putative foreign partners could not realize an economic gain, and could not suffer an economic loss, from their participation in petitioner. *Id.* at 19a-22a. Instead, AlliedSignal paid the parent corporation of the putative partners a substantial, guaranteed fee for creating the subsidiaries to play the role of partners to AlliedSignal. *Ibid.* The court of appeals correctly concluded that the record of this case amply supports the Tax Court's findings that, in these circumstances, no legitimate partnership relationship had been formed for federal tax purposes between AlliedSignal and ABN. *Id.* at 23a.[8] Further review of the factual determinations "concurred in by two lower courts" (*Rogers* v. *Lodge*, 458 U.S. 613, 623 (1982)) is not warranted. See *Tiffany Fine Arts, Inc.* v. *United States*, 469 U.S. 310, 317-318 n.5 (1985).

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[8] Petitioner errs in asserting (Pet. 24-25) that the court of appeals misapplied the standards set forth in *Culbertson* by ignoring the fact that ABN allegedly made a "capital contribution" to the putative partnership. In *Culbertson*, this Court stressed that even a legitimate capital contribution does not necessarily render an arrangement a partnership for federal tax purposes. 337 U.S. at 742. Instead, the controlling inquiry is whether the record as a whole reveals that "the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." *Ibid.* The courts below correctly applied that standard in this case. See Pet. App. 18a.

2. Petitioner errs in contending (Pet. 16) that the decision in this case conflicts with the "principles" enunciated by this Court in *Moline Properties* v. *Commissioner*, 319 U.S. 436 (1943). The *Moline Properties* case addressed the circumstances under which a corporation is to be recognized for federal tax purposes. Petitioner claims (Pet. 16-21) that, in *Moline Properties*, the Court concluded that a corporation should be recognized for federal tax purposes if it either served a business purpose or engaged in business activity. Petitioner contends that the decision in this case erroneously collapsed that two-part test into a test that focuses solely on whether the entity possessed a valid business purpose.

a. Petitioner's reliance on *Moline Properties* reflects a fundamental misunderstanding of that decision. The issue in *Moline Properties* was whether income from the sale of real property owned by a corporation was taxable to the corporation (as the Commissioner contended) or to the corporation's sole shareholder (as the taxpayer contended). The corporation had been formed long before the taxable years in issue to serve as a security device in connection with certain real property owned by the shareholder. Relying on the corporation's status as a "separate taxable entity," this Court ruled in favor of the Commissioner (319 U.S. at 438-439; footnotes omitted):

> The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of

> incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.

The Court emphasized in *Moline Properties* that there were exceptions to the rule that generally recognizes the existence of the corporate form, including cases involving "frauds on the tax statute." 319 U.S. at 439. The Court concluded that the income earned by the corporation was taxable to the corporation in that case, however, because the corporation had served a legitimate business purpose (relieving its shareholder of pressure from his creditors) and had engaged in legitimate business activity (leasing a part of its property for a substantial rental). *Id.* at 439-440. In the Court's view, these facts reflected the fact "that the [corporation] had a tax identity distinct from its stockholder." *Id.* at 440.

The reasoning and holding of the Court in *Moline Properties* has no application to the question whether parties have formed a valid partnership for federal tax purposes. The decision in *Moline-Properties* was based on the fact that a corporation is a "separate taxable entity"—an entity that, by law, is subject to tax on the income it earns. See 26 U.S.C. 11(a). Because a corporation is a separate taxable entity, the shareholders of the corporation are ordinarily *not* subject to tax on the corporation's income. By contrast, a partnership is not itself a separate taxable entity for federal tax purposes. See 26 U.S.C. 701. Instead, the income, losses, and other tax items of the partnership are attributed to its partners and are taxed at the partnership level. See 26 U.S.C. 702(a). Because partnerships are *not* separate taxable entities, the decision in *Moline Properties*, by its very terms, has no bearing on whether parties have formed a valid partnership for federal tax purposes. Instead, as this Court has itself emphasized, that issue is to be resolved by applying the principles articulated by this Court in *Tower* and *Culbertson.*

In *Tower* and *Culbertson,* this Court neither cited nor relied on its prior decision in *Moline Properties.* It is thus obvious, in this context, that the principles articulated in the more recent and relevant decisions of *Tower* and *Culbertson,* and not the reasoning of the prior and unrelated decision in *Moline Properties,* establish the controlling test for determining whether taxpayers have entered into genuine partnerships for federal tax purposes. Indeed, if (as petitioner erroneously contends) the "business activity" test set forth in *Moline Properties* were controlling in determining the existence of a valid partnership for tax purposes, both *Tower* and *Culbertson* would have been decided differently—in favor of the taxpayers. Unlike petitioner, the purported partnerships involved in *Tower* and *Culbertson* were engaged in legitimate businesses. This Court concluded that these entities nonetheless did not qualify as partnerships for federal tax purposes in light of the intent of the putative partners and the nature of their relationship. 327 U.S. at 287; 337 U.S. at 742. The court of appeals did not err in this case in following the same reasoning applied by this Court in *Tower* and *Culbertson.* See Pet. App. 18a.

b. Moreover, nothing in this Court's decision in *Moline Properties* validates blatant tax-avoidance schemes such as the one that the parties sought to construct in this case. *Moline Properties* stands for the straightforward proposition that a corporation that serves a legitimate business purpose or that is engaged in legitimate business activity is ordinarily to be taxed on the income it earns. 319 U.S. at 439. Nothing in that decision, however, suggests that courts are required to treat a relationship that exists only to implement a tax avoidance scheme as a valid business entity for federal tax purposes. To the contrary, the Court stressed that its description of the separate tax status of corporations in *Moline Properties* has "recognized exceptions" and does *not* apply in cases involving attempts to perpetrate "frauds on the tax statute * * *." *Ibid.* It is precisely such a "sham or unreal" (*ibid.*) device to perpetrate an evasion of tax liability that the Merrill Lynch scheme seeks to accomplish here—for AlliedSignal seeks to obtain a $538 million tax loss from participation in a relationship that was developed and structured solely to achieve "phantom" losses for a taxpayer that would, in fact, incur no genuine economic loss from the scheme. *ACM Partnership* v. *Commissioner*, 157 F.3d 231, 245 (3d Cir. 1998) (holding that the Merrill Lynch scheme creates "phantom" losses that are not to be recognized for tax purposes), cert. denied, 526 U.S. 1017 (1999); Pet. App. 22a-23a.[9]

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[9] Other courts have noted that petitioner's contention (Pet. 17-19) that the court in this case erroneously collapsed the "two-part test" of *Moline Properties* into a unitary "business purpose" test "attempts to create a distinction where none exists." *Zmuda* v. *Commissioner*, 731 F.2d 1417, 1420 (9th Cir. 1984). "Business purpose" and "business activity" are two sides of the same coin; both terms are directed at the question whether a corporation is serving a legitimate purpose.

In the present case, the court did not suggest that a corporation engaged in *legitimate* business activity will not be recognized for

c. Petitioner errs in contending (Pet. 20-21) that the decision in this case is in "direct conflict" with *Northern Indiana Public Service Co.* v. *Commissioner*, 115 F.3d 506 (7th Cir. 1997), and *Gregg Co. of Delaware* v. *Commissioner*, 239 F.2d 498 (2d Cir. 1956), cert. denied, 353 U.S. 946 (1957). In those cases, the courts of appeals made fact-specific determinations that the *corporations* in question were engaged in *legitimate* business activities. As discussed above, cases involving corporations do not require the same analysis that *Tower* and *Culbertson* require for partnerships. Moreover, in the present case, petitioner did *not* engage in legitimate business activities. Instead, petitioner was simply a facade constructed in a misguided effort to allow Allied-Signal artificially to employ "phantom" losses to avoid payment of the taxes it owed on the significant capital gains that it derived from the sale of its subsidiary. See pages 2-9, *supra*.

3. Petitioner also errs in urging a newly minted contention that the decision in this case conflicts with *Evans* v. *Commissioner*, 447 F.2d 547 (7th Cir. 1971), "with respect to the proper roles of IRC Sec. 704(e)(1) and *Culbertson* in determining whether persons are partners in a partnership" (Pet. 22). Petitioner did not

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federal tax purposes. On the contrary, it observed that "[i]t is uniformly recognized that taxpayers are entitled to structure their transactions in such a way as to minimize tax." Pet. App. 17a. The court correctly held, however, that in some cases a purported business activity is nothing more than a facade for an abusive tax avoidance scheme. See *ibid.* ("When the business purpose doctrine is violated, such structuring is deemed to have gotten out of hand, to have been carried to such extreme lengths that the business purpose is no more than a façade."). Neither *Moline Properties* nor any other case cited by petitioner suggests that courts are powerless to prevent such schemes from coming to fruition.

make any argument based upon Section 704(e)(1) until its reply brief on appeal. The court of appeals properly declined to address that issue which petitioner belatedly sought to inject into this case. Because the court had no occasion to, and did not, address Section 704(e) in its opinion, its decision in this case obviously does not conflict with any decision (such as *Evans* v. *Commissioner*) that *has* addressed Section 704(e).[10]

Petitioner's invocation of Section 704(e)(1) is, in any event, entirely without merit. Section 704(e)(1) provides an objective, statutory standard for determining whether a particular "person" is a "partner" in a partnership. It does *not* provide a standard for determining whether an arrangement that purports to be a partnership is to be recognized as a valid partnership for federal tax purposes.[11] Section 704(e)(1) states that "[a] person shall be recognized as a partner * * * if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person." 26 U.S.C. 704(e)(1). This statute assumes the existence of a genuine partnership engaged in a *legitimate* income-producing business. See Treas. Reg. 1.704-1(e)(1)(iv) (1981) ("Capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business conducted by the partnership."). The statute thus has no application to, and does not validate, sham arrangements created by tax planners to conjure forth "phantom" losses as part of tax avoidance schemes. When, as in the present case, there is no genuine partnership, there can be no actual partners.

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[10] In any event, *Evans* v. *Commissioner* involved the analytically distinct question whether a partner in an indisputably genuine partnership made a valid transfer of his partnership interest to his wholly-owned corporation. See 447 F.2d at 551-552. The Seventh Circuit resolved that factual issue in favor of the taxpayer in that case. *Id.* at 552.

[11] This Court's decisions in *Tower* and *Culbertson* provide that standard. See pages 11-13, *supra*.

4. Petitioner's rhetorical suggestion (Pet. 25) that this case "raises fundamental issues affecting partnership taxation in a nonfamily setting" is unfounded. This fact-specific case involves a blatant tax-avoidance scheme that offers up "phantom" losses that courts have consistently and properly refused to validate.

Equally unpersuasive is petitioner's contention (Pet. 15-16, 26) that this Court should grant the petition for certiorari because the Court of Appeals for the District of Columbia Circuit is the only circuit to which appeals may be taken by partnerships that are no longer in existence. The question of the validity for federal tax purposes of a purported partnership can, of course, arise in other circuits. In any event, the fact that the District of Columbia Circuit is the appellate venue for extinct partnerships provides no grounds for review of the factual determinations of the courts below that petitioner was merely an artifice for tax avoidance and was not a valid partnership for federal tax purposes.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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No. 00-8

IN THE

Supreme Court of the United States

ASA INVESTERINGS PARTNERSHIP,
AlliedSignal Inc.
(now Honeywell International Inc.),
Tax Matters Partner,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for a Writ of Certiorari
to the United States Court of Appeals
for the District of Columbia Circuit

PETITIONER'S REPLY TO BRIEF IN OPPOSITION

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RULE 29.6 STATEMENT

Petitioner, ASA Investerings Partnership, was an investment partnership formed by AlliedSignal Inc. (AlliedSignal), AlliedSignal Investment Corporation (ASIC), Barber Corporation N.V. (Barber) and Dominguito Corporation N.V. (Dominguito). Of those four corporations, only AlliedSignal (now Honeywell International Inc.) has issued shares and/or debt securities to the public. Algemene Bank Nederland N.V. (now ABN Amro Bank N.V.), the indirect parent of Barber and Dominguito, has issued shares and/or debt securities to the public.

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U.S. Supreme Court Rule 29.6 i

IN THE

Supreme Court of the United States

ASA INVESTERINGS PARTNERSHIP,
AlliedSignal Inc.
(now Honeywell International Inc.),
Tax Matters Partner,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

**On Petition for a Writ of Certiorari
to the United States Court of Appeals
for the District of Columbia Circuit**

PETITIONER'S REPLY TO BRIEF IN OPPOSITION

Respondent frames the Question Presented as "whether petitioner was a valid partnership." Br. Opp. (I). He suggests that petitioner seeks nothing more than a review of factual determinations made by two lower courts. That is not correct. Respondent's own formulation inherently raises the fundamental legal issue here involved -- what is the proper legal standard to be applied in determining the validity of a partnership.

As the Petition for Certiorari establishes, there are three legal standards potentially applicable in determining whether AlliedSignal and ABN were partners in a valid partnership: (1) the *Moline* standard; (2) the Sec. 704(e)(1) standard; and (3) the *Culbertson* standard. The existence of these three competing standards has caused disagreement and conflict among the lower courts as to which standard is to be applied in which circumstances, and even as to how a particular standard is to be applied. Given the confusion that currently exists and the considerable importance of the issue here presented, review of the instant case is fully warranted.

I. The *Moline* Standard.

The D.C. Circuit devoted a substantial portion of its opinion to an application of the *Moline* standard. It applied *Moline* in favor of respondent. Yet, respondent now seeks to disavow the application of *Moline* on the ground that it applies only to corporations and not to partnerships because partnerships are not taxable entities. Br. Opp. 15-16.

Both respondent's disavowal and the grounds offered are surprising. Partnerships are respected as separate entities for tax purposes even though they are not themselves taxable.[1] The Tax Court has had no difficulty holding that *Moline* applies to determine the validity of a partnership from its inception, even though it is not a taxable entity.[2] The court below certainly concluded that *Moline* applies to determine the validity of a partnership from inception.

Respondent's position is undoubtedly influenced by the fact that the D.C. Circuit's application of *Moline* to petitioner directly conflicts with the principles enunciated by this Court in that case. Respondent freely admits that *Moline* applies a two-pronged "business purpose or business activity" test to determine whether a corporation should be respected for tax purposes: "*Moline Properties* stands for the straight-forward proposition that a corporation that serves a legitimate business purpose or that is engaged in legitimate business activity is ordinarily to be taxed on the income it earns." Br. Opp. 17 (emphasis added).

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[1] *United States* v. *Basye*, 410 U.S. 441, 448 (1973).

[2] *Bertoli* v. *Commissioner*, 103 T.C. 501, 511-12 (1994) (*Moline* applied to test validity of partnership formed to hold certain property). See also *Campbell County State Bank, Inc.* v. *Commissioner*, 37 T.C. 430, 442 (1961), *rev'd on other grounds* 311 F.2d 374 (8th Cir. 1963)(with neither side challenging holding respecting separate existence of partnership); *Seminole Flavor Co.* v. *Commissioner*, 4 T.C. 1215, 1234-35 (1945), cited in *Campbell County, supra.*

Accordingly, assuming *Moline* also applies to partnerships, the parties appear to agree that the decision below conflicts with *Moline,* as well as with decisions in numerous other circuits that have applied the two-pronged test articulated in *Moline.*[3]

Respondent hedges his bet on *Moline*. He contends that nothing in *Moline* validates "blatant tax-avoidance schemes." Br. Opp. 16. But that assertion ignores the significance of the Seventh Circuit's decision in *Northern Indiana Public Service.*[4] There, the Antilles conduit arrangement avoided U.S. withholding tax on interest paid to foreign lenders. It could easily be described as a "blatant tax-avoidance scheme." Yet, the arrangement was upheld by the Seventh Circuit under *Moline* because the Antilles subsidiary engaged in bona fide commercial activity.

Respondent seeks to distinguish *Northern Indiana* on the ground that, unlike the Antilles subsidiary there involved, petitioner "did *not* engage in legitimate business activities." Br. Opp. 18 (emphasis in original). However, even the court below acknowledged (App. 15a) that petitioner engaged in extensive legitimate business activity, investing and reinvesting its capital in a wide range of securities throughout its 25-month existence, and earning and distributing $113 million in profits. In contrast, the Antilles subsidiary in *Northern Indiana* merely engaged in a pattern of borrowing funds from overseas, on-loaning the funds to its U.S. parent, and investing the small profit it earned for its role in the scheme.

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[3] See cases cited in Petition for Certiorari 17 n.16.

[4] *Northern Indiana Pub. Serv. Co.* v. *Commissioner*, 115 F.3d 506 (7th Cir. 1997), *aff'g* 105 T.C. 341 (1995).

The decision below is in direct conflict with *Northern Indiana* regarding *Moline*'s application to entities that may have been formed for a tax avoidance purpose, but that carried on legitimate business activity.

II. The Section 704(e)(1) Standard.

Section 704(e)(1) sets forth the second potentially applicable standard for determining whether petitioner was a valid partnership, because capital was a material income-producing factor in its operation. Petitioner believes that if *Moline* is not the proper standard to apply here, Sec. 704(e)(1) is.

Respondent claims that Sec. 704(e)(1) applies only to determine whether a particular person has become a partner in an existing partnership, not whether an arrangement that purports to be a partnership is to be recognized as valid. Br. Opp. 19. But both *Culbertson* and *Tower*, on which respondent relies, involved the validity of newly-formed partnerships, and Sec. 704(e)(1) was enacted to eliminate the confusion spawned by those cases.[5] Does it not follow that Sec. 704(e)(1) must apply to newly-formed partnerships as well as to partnerships already in existence?

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[5] H.R. Rep. No. 586, 82d Cong., 1st Sess. 32-34(1951), *reprinted in* 1951 U.S.C.C.A.N. 1781, 1813-15; S. Rep. No. 781, 82d Cong., 1st Sess. 38-41 (1951), *reprinted in* 1951 U.S.C.C.A.N. 1969, 2008-10.

That was certainly the conclusion reached by the Seventh Circuit in *Evans* v. *Commissioner*.[6] There, Sec. 704(e)(1) was applied to establish the existence of a newly-created partnership following the technical termination of an existing partnership.[7] By applying *Culbertson* in lieu of Sec. 704(e)(1) here, the court below has put itself in direct conflict with *Evans*.[8]

Respondent claims there can be no conflict with *Evans* because the D.C. Circuit "had no occasion" to consider petitioner's "newly minted" Sec. 704(e)(1) argument that was "belatedly" injected into the case. Br. Opp. 18-19. Respondent's position is factually incorrect and therefore without foundation. Petitioner's Sec. 704(e)(1) argument is not "newly minted" and was not "belatedly" offered.[9] The court below had ample opportunity to consider petitioner's Sec. 704(e)(1) argument. It simply chose not to do so.

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[6] 447 F.2d 547 (7th Cir. 1971).

[7] Sec. 704(e)(1) has also been applied by the Tax Court in partnership formation cases. See, *e.g.*, *Ketter* v. *Commissioner*, 70 T.C. 637 (1978) (also cases there cited), *aff'd without opinion*, 605 F.2d 1209 (8th Cir. 1979); *Carriage Square, Inc.* v. *Commissioner*, 69 T.C. 119 (1977). Here, the Tax Court could not have applied Sec. 704(e)(1) because of its holding that ABN had "loaned" its funds to AlliedSignal.

[8] Compare *Bayou Verret Land Co.* v. *Commissioner*, 450 F.2d 850 (5th Cir. 1971), cited by respondent below but not cited in his Brief in Opposition.

[9] Petitioner raised Sec. 704(e)(1) and the *Evans* case in its opening brief on appeal. D.C. Cir. Pet. Br. 30, 32-33. Respondent's responsive brief addressed the merits of the argument, in much the same language that now appears in his Brief in Opposition. Compare D.C. Cir. Res. Br. 51 with Br. Opp. 19-20. Petitioner answered respondent's arguments in its reply brief below, filed August 12, 1999. D.C. Cir. Pet. Rep. Br. 7-9. Petitioner's counsel also referred specifically to Sec. 704(e) in the oral argument held on October 19, 1999. Transcript 4.

III. The *Culbertson* Standard.

Respondent contends that *Culbertson* (along with *Tower*) sets forth the only proper standard for determining whether AlliedSignal and ABN were partners in a valid partnership. Respondent's position is not tenable. Congress chose to enact Sec. 704(e)(1) to bring certainty to an area where the lower courts had become confused following the decisions in *Culbertson* and *Tower*.[10] Congress did not intend to have *Culbertson* remain the governing standard for determining the validity of partnerships where capital was a material income-producing factor.

If *Culbertson* does govern the instant case, the court below failed to apply the *Culbertson* standard properly by refusing to consider whether ABN's cash outlay constituted a capital contribution to petitioner rather than a loan to AlliedSignal. App. 22a. Respondent glosses over this failure by claiming that this Court "stressed" in *Culbertson* that "even a legitimate capital contribution does not necessarily render an arrangement a partnership." Br. Opp. 13 n.8.

Contrary to respondent's view, what this Court "stressed" in *Culbertson* was the importance of determining, from among the facts and circumstances considered, whether the putative partner had contributed services or capital to the venture. *See* 337 U.S. at 742, 744, 748. That is particularly clear from this Court's statement remanding *Culbertson* to the Tax Court to determine which, if any, of the taxpayer's four sons were partners with him in the operation of his ranch.

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[10] See *supra* note 5.

> As to which of them, in other words, was there a bona fide intent that they be partners in the conduct of the cattle business, either because of services to be performed during those years, or because of contributions of capital of which they were the true owners, as we have defined that term in the *Clifford*, *Horst*, and *Tower* cases?

337 U.S. at 748 (emphasis added). In short, a contribution of services or capital to the venture was seen by this Court as strong, if not conclusive, evidence of an intent to be a partner in the venture.

Here, the Tax Court's "loan" determination eliminated the capital contribution issue and thus was a very important factor in its *Culbertson* analysis. Respondent conceded below that ABN's cash outlay did not appear to be a "loan." Yet, the D.C. Circuit refused to address the capital contribution v. loan issue. That refusal cannot be reconciled with *Culbertson*'s requirements.

* * *

Either *Moline* (particularly as applied in *Northern Indiana*), or *Evans* (applying Sec. 704(e)(1)), or *Culbertson* sets forth the proper standard for determining whether petitioner was a valid partnership. It should be apparent from the foregoing that the decision below conflicts, in whole or in part, with each of those decisions. In addition, the decision below is "incompatible with basic principles of income taxation as developed in [this Court's] prior cases." *Basye*, *supra*, at 442. For those reasons, review should be granted.

If the decision below is left unreviewed, its erroneous interpretation of *Moline*, its failure to consider the application of Sec. 704(e)(1), and its misapplication of *Culbertson* are certain to cast a large shadow of doubt over the manner in which lower courts are to determine whether participants in an unincorporated venture are in fact partners in a valid partnership. Guidance from this Court is sorely needed in order to ensure that, in future cases, the lower courts will adopt a proper and uniform approach to resolving the fundamental issue here presented.

CONCLUSION

For all of the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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